ALTERNATIVE
CREDIT COUNCIL

LENDING
FOR GROWTH

Borrower's guide to private credit

www.lendingforgrowth.org

UK EDITION

Foreword

Jiří Król
Global Head of the Alternative Credit Council

The success of Small and Medium Enterprises (SMEs and mid-sized businesses) is vital to the functioning of the British economy. It is crucial for these businesses to have access to the finance they need to invest, grow and provide jobs across the country. Private credit managers offer an increasingly important source of funding for UK businesses, and are currently providing an estimated £100bn of funding to 2,000 UK firms.[i] Additionally, recent data suggests that private credit managers provided a total of £18.4bn of finance in 2018 and 2019 to small businesses in particular.[ii]

Looking ahead, access to finance is likely to be a critical factor for SMEs and mid-sized businesses as they adapt and modernise in response to COVID-19, as well as newer trends in customer demand and behaviour. It is estimated that UK companies currently face a finance gap of at least £22bn[iii], with the true gap potentially much higher. It is therefore essential to cultivate more sources of capital to support businesses across the UK.

As well as increasing the availability of capital, it is necessary to diversify the type of capital which is available. This will support SMEs and mid-sized businesses whose financing needs fall outside the risk appetite of existing capital providers, despite being viable businesses. It will also provide businesses with greater choice and support competitive finance markets.

Private credit managers pride themselves on offering loans that work with the specific needs and circumstances of the borrower. This allows these businesses to invest in their future, create jobs and compete in a global marketplace. Private lenders often specialise in certain business sectors and are therefore able to offer tailored solutions based on a bilateral relationship created with borrowers. In addition, private credit lenders are well placed to support underperforming businesses return to viability and growth, while protecting the value of the business. This is especially important as businesses continue to adjust to the changing economic circumstances as a result of COVID-19.

Despite the growth of the private credit industry in the UK during the past decade, many UK business owners remain unfamiliar with this group of lenders and the lending solutions they can offer.

This introductory guide offers an overview of who private credit lenders are, how they lend and work in partnership with businesses to help them succeed. It outlines whether private credit might be the right fit for a business, how lenders conduct due diligence, what to expect in a loan agreement and what to expect once a loan has been extended. In addition, it includes a glossary of key terms as well as case studies that provide real life examples.

The value of this type of long-term finance is well recognised by both UK businesses and policymakers. The Bank of England, HM Treasury and the Financial Conduct Authority have convened an industry working group to facilitate investment in 'productive finance', which is defined as investment that expands productive capacity, furthers sustainable growth or makes an important contribution to the real economy.

The Alternative Credit Council (ACC) is pleased to participate in this working group and support its objectives. We hope that this guide will complement that work by raising awareness among UK businesses and demonstrating that private credit is an established and viable financing option.

The ACC thanks the British Business Bank, the Confederation of British Industry, the Federation of Small Businesses and the Institute for Turnaround for their support and hope this guide will assist borrowers in considering private credit as a viable option to support the growth of their businesses.

Contents

Executive summary

What is private credit?

'Private credit' is the umbrella term used to describe loans to businesses originated by lenders other than banks. It typically involves lending to companies on a bilaterally negotiated basis, with financing sizes ranging between £10 million and £500 million. Private credit lenders engage with borrowers via direct relationships which helps support their understanding of the borrower's business. This allows lenders to offer flexible and tailored finance solutions to match the unique needs of each borrower.

What businesses do they lend to?

Private credit firms generally lend to Small and Medium Enterprises (SMEs) and mid-market businesses across all sectors of the economy. Businesses use this type of finance for a variety of purposes such as acquisition and expansion plans, improving working capital and refinancing existing debt.

What types of private credit loans are available?

Private credit managers will work with businesses to find the right type of finance for their needs. This means they may lend across a range of maturities and repayment profiles, take into account different types of security, collateral or levels of seniority compared to existing debts. In addition, lenders often specialise in providing finance that is aligned with the needs and circumstances of specific sectors.

How do private credit lenders make investment decisions?

Private credit firms will engage in considerable due diligence and typically invest in only a small percentage of the businesses they assess. This ensures that both the lender and borrower are the right fit for each other. Factors a firm would typically analyse may include a business's sector and key markets, financials, corporate governance, collateral, management culture and, increasingly Environmental, Social and Governance (ESG) factors.

Why is ESG important to private credit lenders?

Private credit managers need to provide their investors with ESG information about the businesses they are lending to. This means that they will ask businesses questions about things such as their energy use, adherence to labour standards and corporate governance. This supports their understanding of how a business is being managed alongside more traditional financial metrics.

Are private credit managers secure counterparties?

Private credit firms are regulated as asset managers and the funds they manage are subject to ongoing regulatory supervision and oversight. Businesses benefit from the same safeguards and borrower protection rules when working with private credit lenders as they would do with any other finance provider.

What does a loan agreement look like?

A loan agreement should stipulate the purpose of the finance sought, the term of the loan, and the conditions of repayment such as interest rates. Loan agreements will also include undertakings or covenants, outlining the terms borrowers agree to comply with and upon which the provision of the loan is conditioned. An example term sheet can be found on **page 27** of this guide.

What happens if a business experiences distress?

The direct relationship between a borrower and private credit manager means that any periods of stress or challenging circumstances are likely to be identified early. This provides more time for both parties to proactively engage and address any issues. The individuals working with a business to mitigate the stress will often be the same people who were involved in the initial lending process. This means they will have a detailed understanding of the business and its market to better inform how to get back on track.

Private credit managers offer an increasingly important means of funding UK businesses, and are currently providing an estimated £100bn of funding to 2,000 UK firms

Is private credit the right choice for your business?

Defining private credit

Private credit is an increasingly important source of finance for borrowers, enabling them to invest in their businesses and support job creation and innovation. Much of the overarching terminology used to describe private credit is applied interchangeably with phrases such as 'direct lending', 'alternative lending', 'non-bank lending' and 'private debt' all part of the common parlance. 'Private credit' is the umbrella term used to describe all forms of credit provided by non-bank lenders.

Private credit typically involves lending to companies or projects on a directly negotiated basis, with typical financing sizes ranging between £10 million and £500 million. It is not publicly traded, as is the case with many corporate bonds, and is originated or held by lenders other than banks. Private credit takes various legal forms including loans, bonds, notes or private securitisation issues.

The direct and tailored nature of private lending is often the core element that distinguishes private credit from other forms of financing.

Many firms view themselves as a partner to the businesses they have lent to, and have business models which rely on the ongoing success of their borrowers.

Borrowers use private credit loans for a variety of purposes such as pursuing acquisition and expansion plans, improving working capital and refinancing. Among the most popular borrowers of private credit are SMEs and mid-market companies, however, many private credit firms cater to larger businesses.

Key advantages of private credit

Obtaining financing through private credit lenders offers three key advantage to borrowers:

01 / Direct Relationship

Private credit firms distinguish themselves through the collaborative relationship maintained with companies in their portfolio. Businesses tend to engage with the same individuals throughout the due diligence process and lifecycle of the loan. The relationship that is created is one built on trust and a deep understanding of the borrower's business on the part of the lender. It is this long-term relationship which is at the epicentre of why many businesses prefer to obtain financing through private credit lenders. Having provided the borrower with a loan tailored to his or her business, private credit lenders are better equipped to handle any periods of uncertainty which may arise throughout the lifecycle of the loan. Due to the close relationship established between borrowers and private credit lenders, renegotiating terms and making adjustments is based on stronger foundations and deeper knowledge.

02 / Tailor-made solutions

In recent years, private credit has increasingly provided an alternative means of finance to markets which are being underserved by traditional sources of finance, such as SME lending, speciality finance, real estate, trade finance and infrastructure debt. This development of such niche finance solutions more readily matches the needs of the borrower and the interests of the lender. Moreover, borrowers appreciate private credit lenders' ability to navigate the more complex financing situations required by some businesses to meet their lending needs.

03 / Speed

Despite the in-depth due diligence processes employed by private credit lenders, loan decisions are made quickly and efficiently. This enables borrowers to take advantage of time-sensitive market opportunities.

How do private credit managers lend?

Private credit managers pride themselves on offering loans that work with the specific needs and circumstances of the borrower. This means they can provide loans to borrowers using several different methods – for example, using different types of security or collateral, and at different levels of seniority compared to existing debts.

Figure 1 provides an overview of the typical structure of loans and equity that a business may offer to investors. The capital stack is a ranked representation of the order in which debt and equity holders are given access to a company's assets in the case of default. Typically, senior debt holders rank highest whereas common equity holders rank lowest.

> *Private credit managers pride themselves on offering loans that work with the specific needs and circumstances of the borrower*

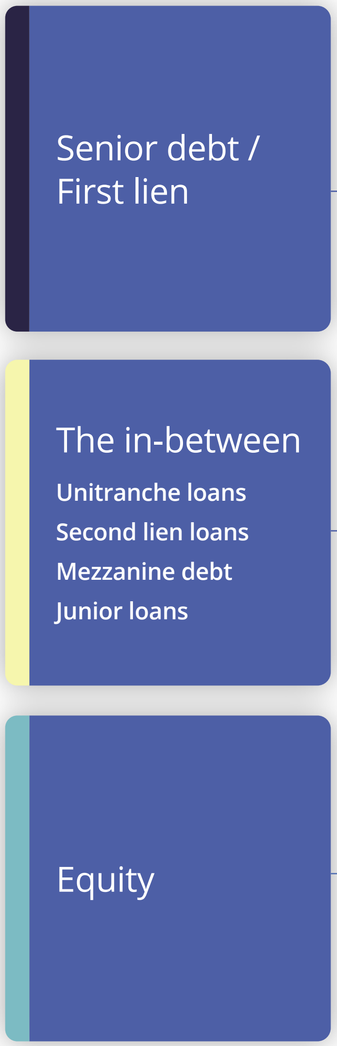
Case study

Scottish real estate investment financed by Omni Property Finance

In November, Omni Property Finance Limited ("OPFL") was approached by a Scottish borrower who focuses on purchasing distressed properties (at a discount). The borrower typically identifies assets to refurbish and hold as part of his income-producing property portfolio. The borrower was seeking finance to acquire a four-storey commercial building near the central rail station in Glasgow, Scotland and needed to act quickly. A few months earlier the borrower had identified the building as a potential investment opportunity and participated in a tender offer process.Having been outbid, the borrower shifted his attention to other acquisition targets.

The agent got back in touch with the borrower after the original purchaser was unable to secure financing. The agent accepted the borrower's discounted bid subject to a short completion time frame. After the borrower contacted OPFL, the underwriting process commenced immediately. The borrower was able to complete within the stipulated timeline – the acquisition was finalised within two weeks of initial contact. The loan was structured with a 15-month term at a loan-to-value of 60%. The borrower will meet interest payments from rental income and the 15-month duration allows the borrower sufficient time to refinance the loan on to a long-term commercial refinance.

Figure 1: Capital stack



Senior debt / First lien

First lien loans rank highest in the capital stack. This means that such loans are prioritised against most assets, often including the capital stock of the business. Inversely, the borrower is typically charged a lower amount of interest to reflect the relative security of the loan.

The in-between

There are several other positions within the capital stack ranking in priority below senior debt but above common equity, or potentially combining debt and equity positions, that private credit lenders may be willing to take. The interest rate paid is typically proportional to the level of risk associated with the loan / equity structure and the relative seniority in terms of access to capital. Borrowers may appreciate the simplification of such a structure as a 'one stop' source of financing with limited syndication risk. Examples of common terms a borrower may come across in this context are:

- **Unitranche loans:** Unitranche loans combine a senior tranche of debt and a junior tranche of debt in a single loan and provide a blended return to the lender.
- **Second lien loans:** Second lien loans usually form part of a wider senior debt package and will be lent at the same level in the structure as senior debt.
- **Mezzanine debt:** Mezzanine is a form of junior debt issued under separate documentation to the senior debt that ranks in priority behind the senior debt, but ahead of equity and is typically provided in conjunction with senior debt.
- **Junior loans:** Junior, or subordinated, loans have lower repayment priority than senior and mezzanine loans in the case of default and are closer to equity in the capital structure. As such, they run a higher risk of not getting repaid if a borrower defaults and hence pay higher coupons.

Equity

Equity represents the shares of ownership of the business. Shareholders will only be repaid after all debt commitments have been fulfilled. Therefore, equity ranks lowest in the capital stack. Direct lenders will generally not be involved in equity financing, but an equity component often finds its way as an addition to a debt portion of financing, usually in the form of equity warrants granted to the lender.

What types of private credit loans are available?

It is important to note that the universe of private credit loans is a broad one, with a selection of common strategies defined below. Within each strategy, a private credit manager may choose various loan seniorities according to the capital stack (see Figure 1).

Asset-based finance

Asset-based lending describes companies or other entities borrowing money secured against the value of assets they own. Common assets that are provided as collateral for an asset-based loan include physical assets like real estate, land, inventory, equipment and machinery, or intangible assets such as intellectual property. Asset-based lending is suited to organisations that require working capital to operate and grow, particularly in industries that might not provide significant cash flow potential.

Cash flow finance

Cash flow financing is a type of lending in which a loan made to a business is secured by a company's expected cash flows. The equity of the company to which the private lender provides the financing can therefore be considered as the collateral of the loan. The key financial metric used in assessing the creditworthiness and the amount of the loan to the business is the quality and size of its EBITDA. This is explored further in the following chapters.

Infrastructure debt

Infrastructure debt involves the financing of long-term infrastructure and industrial projects whereby repayments of the debt are funded by the cash flow generated from the completed project.

Real estate finance

Real estate finance involves the provision of credit secured against an underlying real estate asset. This type of financing may entail the funding of the initial purchase and construction phase of a commercial property, or the funding of a more general investment and enhancement strategy in existing commercial property.

Rescue finance

Rescue finance can be defined as the loans provided to companies that have filed for bankruptcy or have a significant chance of filing for bankruptcy in the near future. Rescue finance can be an opportunity to invest in a business which has the potential to use such additional funds to turnaround the company and enable renewed success.

Trade finance

Trade finance enables borrowers to purchase specific goods in both domestic and international markets. This is often transactional, with finance only being provided for specific shipments of goods and for specific periods of time. The debt is secured against the goods being financed. Until the borrower repays the debt, the goods typically belong to, or are secured in favour of, the lender.

Venture debt

Venture debt or venture lending refers to loans provided to early stage companies which enables such businesses to proactively fuel growth. As early stage companies typically do not have significant assets or cash flows, access to traditional bank loans is often restricted. Thus, venture debt can be a powerful financing tool.

Private credit and other financing sources

	Private credit	Private equity	Traditional banking	Public debt	Broadly syndicated loans
Typical relationship with borrower	Bilateral, direct	Bilateral, direct	Intermediated, often syndicated	Individual bond holders	Syndicated, banks and investment banks are key intermediaries
Typical borrower	SMEs or mid-market companies	SMEs, mid-market companies and large businesses	Larger businesses	Large, often multinational, businesses	Non-investment grade businesses on the higher end of mid-market and larger corporates
Backing	Usually secured by assets	Access to equity	Usually secured by assets	Secured and unsecured	Usually secured against lender equity
Use of ratings	Not rated	Not rated	Rated	Rated	Usually rated
Typical agreement	Bespoke and heavily negotiated	Bespoke and heavily negotiated	Standardised	Standardised	Standardised
Typical size of financing	10 - 500m	Variable	Variable	500-5bn	250m-1bn
Typical coupon	Floating (LIBOR+) [1]	n/a	Floating (Libor+)	Fixed	Floating (Libor+)
Typical maturity	3-7 years	n/a	Variable	Variable	3-7 years
Liquidity profile	Non-tradable	n/a	Tradable	Tradable	Tradable

1 LIBOR, which stands for London Interbank Offered Rate, serves as a globally accepted key benchmark interest rate that indicates borrowing costs between banks. Most interest rates in loan contracts are set on the basis of Libor. Libor is currently being phased out by macroprudential regulators and replaced by SONIA and SOFR (see Appendix).

Private credit and other financing sources

Banking

Private credit firms have close ties with traditional banks, and many have formed partnerships. Many companies financed by private credit have obtained bank financing either prior to or during their involvement with the private credit manager. When companies have been unable to secure bank finance, it is important to understand that this may not necessarily be due to them having a poor credit history, but rather due to a bank's risk appetite or existing exposure. An increasingly popular trend in recent years is banks and non-banks working alongside each other to provide the borrower with the best available finance option across their different business needs. Furthermore, companies are seeking to diversify their sources of funding and want to access the tailored solutions that private credit managers can provide. Private credit should be viewed as a complementary element of the financial services sector, rather than competing with traditional banking.

Corporate bonds

Bonds are public or private loans made to large organisations. These include corporations, cities, and national governments. Traditionally, corporate bonds and retail bonds are publicly traded on the stock market. They have a predetermined maturity date when the bond is redeemed, and investors are repaid their original investment. For a borrower, issuing public corporate bonds carries additional disclosure requirements. Credit rating agencies assess the quality of the company issuing bonds through a grading system according to the entity's ability to repay these loans. Due to this ratings requirement, issuing corporate bonds requires a high level of public transparency. Opting for a private loan carries the key advantage of limited disclosure, as a borrower's financial data is accessible only to the firm that is providing the loan and no public credit rating through an agency is required. Bonds are typically only available to larger companies and are not considered to be suitable for SMEs.

Private equity

Private equity describes finance provided in return for an equity stake in the company receiving the investment. Often, private equity firms aim to purchase significant shares in a business in order to exercise influence on its management. Due to this ownership dynamic, the private equity firm has a vested interest in the business's success and aim to improve its growth potential by leveraging internal expertise.

Sponsored lending is a type of private credit loan closely associated with a private equity firm which owns shares in the business seeking a loan and acts as a sponsor. Loans which do not involve sponsored lending are described as direct loans. In sponsored transactions, the private equity firm's expertise and relationship with both the borrower and private credit manager often helps to facilitate the loan. Businesses partially owned by private equity sponsors represent only a small percentage of all businesses, yet the majority of finance provided by private credit firms has involved sponsored lending.

When it comes to working without a sponsor, a private credit lender often has to invest more resources to conduct the necessary due diligence when engaging in such direct lending, which partly explains why sponsored lending remains popular. Due to the increased value and time offered to the businesses in direct lending arrangements, as well as the increased risk borne by lenders, direct lending is typically associated with higher costs for the borrowers. However, direct lending is a key area of growth and investment for private credit firms, with many predicting that this business segment will soon match sponsored lending. In addition to the wealth of opportunity in this space, private credit firms value the ability to establish a direct relationship with the borrower, as opposed to an engagement mediated by a third party.

How is private credit regulated?

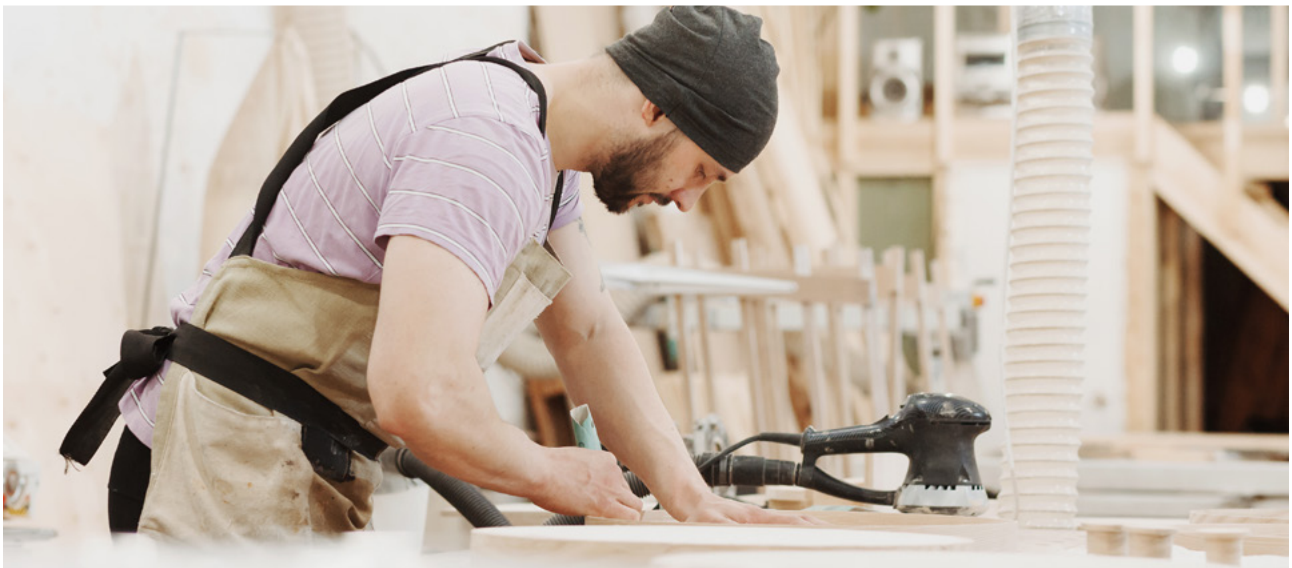
Oversight of private credit lenders in the UK

One of the most common myths about private credit firms is that they are unregulated or lightly regulated, especially when compared with traditional banking. This is incorrect. Private credit firms are regulated as asset managers and the funds they manage are subject to regulatory rules and oversight in relation to their conduct and lending activity. In addition, regulators routinely monitor and assess how a private credit manager is managing its business and any potential risks arising from its lending activity. A private credit firm is required by law to disclose information regarding the performance of its risk management function.

Moreover, the firm's investors, who are often large institutions such as insurance and pension funds, will also require similar disclosures. Should a firm fail to meet its disclosure obligations to a regulator, it will be subject to regulatory sanctions up to and including withdrawal of their authorisation.If a firm fails to meet an investor's disclosure requirements as set out in the investment mandate, it could face commercial and reputational consequences, which may include legal action. Anyone borrowing from a private credit manager will be engaging with a counterparty that is accountable to both their own investors as well as their national regulator.

Is private credit riskier than bank lending?

Businesses obtaining finance from private credit firms benefit from the same safeguards and borrower protection rules as they would with other lenders. While any borrower should always be diligent in their choice of lender, their interests are equally protected with private credit managers as they would be when choosing a traditional lender. In fact, due to the direct and close relationship between private lenders and borrowers, their interests are more closely aligned. Private credit lenders are accountable to a base of investors often representing large pension and insurance funds. These investors expect private credit managers to maintain a portfolio of successful loans and have allocated capital to them on that basis. Private credit firms therefore have no interest in being owners of businesses, but instead make loans with the intention of taking all necessary steps to help borrowers to meet the prescribed terms of the loan.



How the British Business Bank is supporting UK SMEs

Businesses need to get ready for the financial recovery armed with the right information

Over the last year, many smaller businesses have had to adapt or change how they operate and trade. Some have had to secure access to financial support, perhaps for the first time, to survive the crisis while others, unfortunately, have had to cease trading. Those that have weathered the economic storm created by COVID-19 are now planning their next steps, and their success will be vital to a sustainable nationwide economic recovery.

For many businesses, the British Business Bank only came onto their radar through the COVID-19 loans schemes, that were created and deployed at speed during 2020, to support businesses across the UK. Two were especially relevant for smaller business and sole traders: the Coronavirus Business Interruption Loan Scheme and the Bounce Back Loan Scheme. Over the past 12 months, the Bank has helped deliver £75 billion of emergency finance through these and other schemes to support 1.6 million UK businesses.

Businesses which have taken out a Bounce Back Loan over the last year will now be deciding how and when, they start repaying that loan. The scheme began in May 2020 and included a one-year payment holiday, so the first monthly repayments fall due from May 2021. To help businesses further, the Chancellor announced back in September 2020 that businesses would be able to use a series of options for Bounce Back Loans to help those borrowers get back to regular trading. These measures, known as 'Pay As You Grow' give businesses more time and flexibility to pay back the loan. Business can ask to extend their loan term from six to ten years, ask for a six-month payment holiday or pay the interest only for up to three periods of six months.

The British Business Bank is about far more than the COVID-19 emergency loans that the Government asked it to provide over the last year, however. Our core activities, outside the COVID-19 schemes, support more than £8.1bn of additional finance to over 93,000 smaller businesses.

Based in Sheffield and London, the Bank is the Government's economic development bank; our role is to make finance markets work better for smaller businesses so they can overcome barriers to accessing the finance, information and support they need to help them succeed.

We use funding and guarantees backed by the Government to increase the volume and diversity of finance available to smaller businesses. We don't generally lend to or invest in businesses directly, but rather do so through nearly 200 accredited partners – from big retail banks to a vast array of alternative lenders.

As well as making the supply side of financial markets work better, we want impartial financial information and advice to be available to all businesses so they can find the finance best suited to their needs. There are ambitious businesses all across the UK, but often their growth ambitions aren't realised because the financial landscape is complex, misunderstood and difficult to navigate.

Our recent Small Business Finance Markets report found that businesses are becoming more self-reliant when considering what type of finance to apply for and who to apply to. Over a third drew on their own knowledge, their staff's knowledge or previous experience. But we know that businesses benefit from independent, unbiased information that can help them make the right decisions.

For smaller businesses seeking finance there are vast amounts of information on the internet. While this can be a valuable resource, there are times

when small business owners will be overwhelmed by advice and information.

It's essential that smaller businesses are helped at every stage of their development to understand the financial landscape which they are operating in, make the right choices regarding financing their business and to access the funding that it right for them.

In order to do this, the British Business Bank created the **Finance Hub** – an interactive website, developed with a range of industry partners and business groups. Originally, dedicated to providing independent information on finance options for scale-up, high growth and potential high growth businesses, the Hub adapted to the changing economic situation early last year to provide more content on business survival and recovery. Usage of the Bank's Finance Hub has increased by over 20% in the last year, highlighting the usefulness of its offering to smaller businesses throughout the challenges of the pandemic.

Fundamental to The Hub is providing independent and impartial information on finance choices, and it includes a simple six-step 'Finance Finder' that helps smaller businesses explore which finance option will work best for their business. Users are also able to access insights and learning from other real businesses who've been there and faced the issues they now face. The site also has short films, expert guides, checklists and articles from finance providers to help make their application a success and helps guide businesses through the actual process of applying for finance.

Supporting smaller, more diverse businesses is at the heart of what we do at the British Business Bank. We know that the UK's six million smaller businesses are of vital importance to the UK economy, employing nearly 16.8m people and representing over 60% of all private sector employment. In 2021 and beyond, ensuring they find the relevant information they need to make business decisions is crucial for their success, and that of the wider UK economy.

Angelene Woodland
Chief Marketing Officer, British Business Bank

Assessing eligibility

Understanding the investment process

Understanding how private credit firms assess whether to lend to a company is crucial to understanding whether private credit is the right finance option for you.

While each private credit firm will subscribe to a unique investment mandate according to the firm's ethos, all reputable private credit firms will engage in considerable due diligence and typically invest in only a small percentage of the businesses they assess. This ensures that both the lender and borrower are the right fit for each other. As private credit firms may specialise in one sector or geography, borrowers should consider various firms when searching for funding options. Advisors can assist borrowers with identifying suitable lenders.

The diagram opposite outlines the core process a business should expect to undergo when attempting to obtain financing through a private credit firm. The timeframe associated with these steps can take several months to be completed, however, a large number of borrowers are unlikely to be taken forward in the early stages of the process. Throughout the investment process, lenders typically consult third party experts and other external research providers.

Case study

Apollo provides CVC with bespoke capital solution to finance the acquisition and growth of System C, a UK health software leader

Apollo Global Management, Inc. (together with its consolidated subsidiaries, "Apollo" or the "Firm") announced that certain funds managed by its affiliates ("Apollo Funds") have provided debt financing to CVC for its acquisition of System C, the UK's leading provider of health and social care software and services.

The financing was comprised of a £115m unitranche facility and a further committed acquisition facility to support the company's expansion plans.

System C provides vertical software solutions for hospitals, social care, immunisation management and population health that help to improve the quality and efficiency of patient care. The bespoke financing solution provided the company and CVC with both flexibility and available capital to help deliver its ambitious growth plan.

Typical private credit investment process

1. Lender receives information on many investment opportunities through advisors, banks, private equity firms and own network
2. Borrowers are filtered according to broad criteria of investment mandate (industry, business size, geography)
3. Borrowers undergo a detailed review and pre-assessment
4. Borrower is screened by the investment committee
5. Preliminary term sheet / loan agreement is issued to the borrower
6. Complete due diligence
7. Final review by the investment committee
8. Borrower is presented with a final loan agreement / term sheet
9. Loan is issued

Due diligence - What is a ‘good fit’?

Private credit firms undertake an extensive due diligence process to identify whether a business is a ‘good fit’ for the firm’s investment mandate. It is in the best interests of private credit firms to lend responsibly and be diligent when assessing a borrower’s creditworthiness and ability to repay financing. As well as being critical to the success of the private credit firm, there are regulatory and investor requirements to ensure that the firm has robust risk management systems in place.

While equity investors place great emphasis on the growth trajectory of a business in order to increase the value of their ownership stake, private credit managers seek to ascertain whether a potential borrower will be able to repay the loan and interest the business has been given. The following provides an indication of the factors a firm would typically analyse in the course of its assessment.

Case study

BBI group financed by Ares

Headquartered in Wales, BBI Group (“BBI”) specialises in the provision of critical components and services to the in-vitro diagnosis (“IVD”) industry. The global business operates across six sites with c.400 employees through two divisions: i) BBI Solutions (~85% of EBITDA) provides critical components for diagnostics testing to a diverse range of life science and food safety companies, and ii) BBI Healthcare (~15% of EBITDA) is consumer focused and provides prescription and over-the-counter natural products. The company is owned by Exponent Private Equity (“Exponent”).

In April 2020, Exponent was interested in working with a lending partner to support the refinancing of existing BBI debt as well as the acquisition of a complimentary business target in Germany.

The European Direct Lending strategy of Ares Management Corporation (“Ares”) was well positioned to be the direct lending partner given an ability and willingness to provide certainty for the full financing requirement, including additional follow-on funding notwithstanding heightened uncertainty in the market due to COVID-19. Ares also had prior experience in the IVD sector, having previously reviewed and screened a number of IVD manufacturers and reviewed and financed assets in the healthcare space more generally.

Subsequently in May 2020, Exponent mandated Ares as the financing provider of a £115 million first lien facility with a further committed acquisition facility and stapled equity investment alongside management and Exponent.

Following its due diligence, Ares was comfortable lending to BBI, on the basis of the following characteristics it determined to be exhibited by the business:

1. Established position as the sole supplier to a diversified portfolio of blue chip customers
2. Strong barriers to switching providers due to a lengthy and costly supplier re-registration process
3. Strong safety and regulatory compliance track record
4. Highly experienced management team and sponsor, with a track record of organic growth and demonstrated ability to win new business
5. Attractive financial profile with stable product margins

In which sector does the business operate?

Private credit firms often specialise in specific sectors, for example, agriculture, automotive, retail, healthcare or real estate. The private credit manager will seek to finance businesses within that space, as the firm will be able to undertake a more sophisticated analysis of the competitiveness and trajectory of the sector, as well as the ability to more accurately assess the creditworthiness of the business. In the long term, a private credit firm will be a better partner to borrowers within its chosen sectors, so this is likely to be one of the first things that determine whether or not they are a good fit for you.

In the long term, a private credit firm will be a better partner to borrowers within its chosen sectors

Where does the business operate?

Knowledge of commercial and regulatory requirements for the countries in which the business operates enables the private credit manager to better understand and predict how the borrower's business may be affected by broader macro-economic and regulatory conditions. As a result, a borrower should expect that a private credit firm may enquire about:

- Regulatory filings, licences, permits and regulatory approvals in the jurisdictions in which it currently conducts or intends to conduct business
- The potential effect of any pending or proposed regulatory changes
- Any pending or threatened proceedings or investigations before a court or regulatory authority

Assessing the balance sheet

There are three key concepts which underpin a private credit manager's assessment of your business:

1. **EBITDA:** The key measure used to assess a business's financial performance is EBITDA which stands for **E**arnings **B**efore **I**nterest, **T**axes, **D**epreciation and **A**mortisation. In practice, EBITDA is a metric of a business's profits that can be used to showcase a firm's financial performance without accounting for its capital structure. Despite its widespread use, EBITDA is not part of the Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) due to considerable differences in how the figure is calculated. This is further complicated by the concept of adjusted EBITDA and add backs. **Adjusted EBITDA** differs from the standard EBITDA measure in that it is used to normalise income and expenses, as companies may have unique expense items such as redundant assets, bonuses paid to owners, rentals and other one-off costs. These items are referred to as **'add backs'** as they are added back to the net profit value of the company. It is commonplace for private credit managers to look at adjusted EBITDA as it more accurately reflects the financial position of a business.

2. **Leverage ratios:** A leverage ratio is a financial ratio that indicates the level of debt held by a business against other measures in its balance sheet, income statement or cash flow statement. The debt / EBITDA ratio measures a company's ability to repay its debts. A high ratio may indicate that a business's debt load is too high to consider advancing further loans. Other types of leverage ratios include:
   - Debt-to-Assets Ratio = Total Debt / Total Asset
   - Debt-to-Equity Ratio = Total Debt / Total Equity
   - Debt-to-Capital Ratio = Total Debt / (Total Debt + Total Equity)
   - Debt-to-EBITDA Ratio = Total Debt / Earnings Before Interest Taxes Depreciation & Amortisation (EBITDA)
   - Asset-to-Equity Ratio = Total Assets / Total Equity

3. **Loan-to-Value (LTV):** The LTV ratio compares the size of a loan to the value of the asset on which the loan is based. The LTV ratio is an important metric that assesses the risk a lender carries by providing the loan to a borrower. Difficulty may arise if the value of the loan is significantly higher than the value of the asset, as this reflects a risk for the lender in the event of a default.

In addition to the above key criteria, a private credit firm may also request additional information, such as:

- Current and past balance sheets, income statements, cash flows and liquidity
- Current budgets and projections including business plans and projections for product sales and cost of sales
- Projected financials for the term of the requested loan (e.g. five-year term = five-year forecast)
- Latest accounts receivable, accounts payable, aged debtors and creditors reports
- All local and foreign tax returns
- Current debt schedule (including payment history)
- Seniority structure for existing debt
- Existing material charges
- Any auditor's letters and reports to management
- Insurance policies

Collateral

Assessing a company's value requires an overview of its assets, of both physical assets and intellectual property. Collateral is the most common way to mitigate the risk a lender takes on when providing a borrower with a loan. It acts as a security, should the borrower be unable to repay the lender. This is particularly relevant for loans that are not primarily reliant on a company's cash flow but rather its assets. As part of the lender's due diligence process, independent evaluations of collateral are usually commissioned to ensure an objective assessment of its value. Collateral, in the case of secured lending, by itself should not be a predominant criterion for approving a loan and cannot by itself justify the approval of any loan agreement.

Management and employees

Effective management is crucial for a business to continue to function throughout the lifecycle of the loan. Private credit managers will assess the leadership of a business according to tangible and intangible factors. Examples of relevant factors include experience, education, team size and advisors. Due to the direct and bilateral relationship established in the process of obtaining private credit financing, trusting the borrower's management team is a crucial part of the firm's decision-making process.

Therefore, a business may be asked to provide:

- Corporate management organisation chart including titles and backgrounds of all senior officers
- Employee handbooks and policy manuals
- Employment agreements and consulting agreements, severance and collective bargaining agreements, and confidentiality and non-disclosure agreements
- Summaries of all threatened, outstanding and concluded litigation and arbitration proceedings

Case study

£75.5m whole loan to support London Residential Development Financing provided by Cheyne Capital

Cheyne Capital provided a £75.5m whole loan to support the redevelopment of a former fire station into a predominantly residential scheme, comprising 199 apartments. The investment will benefit the wider local community through the provision of a school, sports hall and open space public amenity, as well as a £13.8m off-site affordable housing contribution. The loan was provided with a 3 year term.

How sustainable is the business?

ESG criteria have become firmly established as standard in the financial sector to answer the question of how sustainable a business may be in the long term.

As a long-term investor, a private credit lender will therefore screen borrowers according to ESG criteria to assess the longevity of the business.

How each private credit lender interprets and values ESG considerations is different. However, a manager may broadly distinguish between positive and negative ESG screenings or look to make investments according to ‘impact’ driven objectives.

1. Positive ESG screening

This describes the use of environmental, social, and governance factors when assessing a potential borrower. Fundamentally, ESG integration is predicated on the notion that ESG factors can be financially material to investment performance and can, in turn, lead to superior financial performance. The notion that a well-run company tends, on balance, to deliver better financial performance than one which is run poorly is relatively uncontroversial. ESG factors can also be thought of as risk factors, such as the risk that a company’s practices may not be sustainable in the long term due to the environmental degradation they cause, or an unrepresentative leadership team may represent a limited viewpoint or ineffective internal governance of the business.

Responsible investment should not be viewed as a rigid one size fits all model or checklist of issues to be considered in isolation, but instead as an overarching framework tailored to each business. Naturally, expectations of compliance with key ESG considerations are proportionate to business size and capabilities. As the importance of ESG grows, it is prudent to consider how a business may perform against the factors a private credit manager is likely to consider when making lending decisions. It is often the case that businesses are already taking actions which would be considered in line with ESG criteria, so it may simply be a matter of adequately recording and reporting existing measures.

2. Exclusionary / negative screening

This approach focuses on doing no harm and involves the exclusion of certain sectors from investment based on products or services, or certain behaviours that an investor deems undesirable for moral reasons which have a detrimental impact.

3. Impact investing

More rigorous forms of responsible investing, going beyond the above, are known as impact investing, which requires a company to invest capital in order to create measurable social or environmental goods. In many ways, impact investing bridges the gap between traditional investing and philanthropy, by deliberately creating societal benefits whilst also generating profits.

Table 1: United Nations Principles for Responsible Investment (abridged) [iv]

The below table is an example of the questions a private credit manager may ask as part of their approach to responsible investing.

Overall	Does your business have an ESG policy?
	Does your business track and monitor ESG initiatives?
Environment	Does your business have an environmental policy?
	Are you able to estimate the CO_2 footprint of the business?
	What is the water or energy consumption of the business?
	Does your business operate a waste recycling policy?
Social	Are you planning to create further jobs through the expansion of this business?
	Do you enforce a diversity and inclusion policy?
	Do you follow fair labour practices?
	Describe your recruitment process and average retention rates
	Do you abide by an equal opportunities policy?
	Do you maintain a data security and privacy policy?
	Do you abide by the Modern Slavery policy?
Governance	Does the business have independent member(s) of its board?
	Does the business abide by a corporate code of ethics?
	Do specific committees exist and what are they tasked with?
	Do you engage in systemic risk management?
	Do you maintain transparency of payments?

Loan agreements and monitoring

Understanding loan agreements

While it is highly advisable to seek professional advice when negotiating the terms of a loan agreement, this section offers a basic introduction to the key issues to keep in mind when reaching this stage in the process. From a private credit manager's perspective, documentation is a crucial element of maintaining a rigorous investment process as loan documentation should appropriately reflect the risks identified in the due diligence process. A detailed overview of common terms included in loan agreements can be found in the Appendix.

Case study

LendInvest steps in with a £3.6m Development Exit loan following Covid delays

As a result of Covid, an experienced developer working on a 9 unit scheme in Surrey experienced delays which pushed completion behind schedule and meant planned sales were delayed.

Approaching practical completion with a development facility but needing to wait longer to sell the units, they were introduced to LendInvest to refinance onto a Development Exit facility to secure the completed properties while they were sold.

This refinancing gave them the breathing space of further time to sell remaining units, settle anxious investors during an uncertain period and clear outstanding debt. The loan was structured at a loan-to-value of 69%.

1.

Purpose and loan term

A loan agreement should stipulate: (a) the purpose of the finance sought; (b) the term of the loan; and (c) the conditions of repayment such as interest rates. It is important for the borrower to clarify and define which type of finance is most appropriate for the needs of the business.

2.

Interest rate

Another key concept to understand is the type of interest rate a lender may charge. Generally, a loan agreement will stipulate interest rates as either fixed or floating/variable. Fixed interest rates remain the same throughout the lifecycle of the loan, and the floating/variable rate will change in line with a reference rate. This reference rate has typically been LIBOR (London Interbank Offered Rate), which is currently being phased out. An explanation of alternative rates is included in the Appendix.

3.

Covenants

Loan agreements are generally composed of undertakings or covenants, outlining the terms borrowers agree to comply with and upon which the provision of the loan is conditioned. Covenants are split into positive, negative and financial duties.

Types of financial covenants

Financial undertakings, or covenants, govern the financial position and health of the borrower and set out the parameters within which the borrower must operate. Financial covenants can be grouped into two broad categories – incurrence and maintenance covenants. An incurrence covenant only takes effect if the borrower is taking a specified action, meaning that they must be met only at the time of incurrence, whereas a maintenance covenant requires the borrower to maintain a certain level of activity and is typically tested at regular intervals. Common covenants include:

- Coverage: requires the borrower to maintain a minimum level of cash flow or earnings relative to specified expenses, most often interest, debt service and fixed charges;
- Leverage: sets a maximum level of debt relative to either equity or cash flow, with total debt-to-EBITDA level being the most common;
- Current ratio: requires the borrower to maintain a minimum ratio of current assets to current liabilities;
- Tangible net worth (TNW): requires that the borrower has a minimum level of TNW, often with a build-up provision, which increases the minimum by a percentage of net income or equity issuance; and
- Maximum capital expenditure: requires the borrower to limit capital expenditure to a certain amount in a given period.

Types of non-financial covenants

Non-financial covenants are promises made by the borrower that are not financial but tend to be operational, legal, tax or insurance related in nature. Loan agreements tend to contain both positive and negative non-financial covenants.

Positive covenants prescribe the conditions necessary to maintain the stability of the borrower's business. Examples include:

- Requirement to maintain the corporate existence
- Requirement to maintain insurance policies
- Requirement to request permission from the lender when the entity is considering some form of change of ownership

Negative covenants list various activities that the borrower may not engage in without the lender's consent, while allowing enough flexibility to carry out their business. Examples include:

- Restriction on merger or acquisition deals without lender consent;
- Restrictions on substantial changes within the borrower's business;
- Restriction on investment activities without the lender's permission;
- Restriction on dividend distribution; and
- Restriction on the sale of assets without consulting the lender.

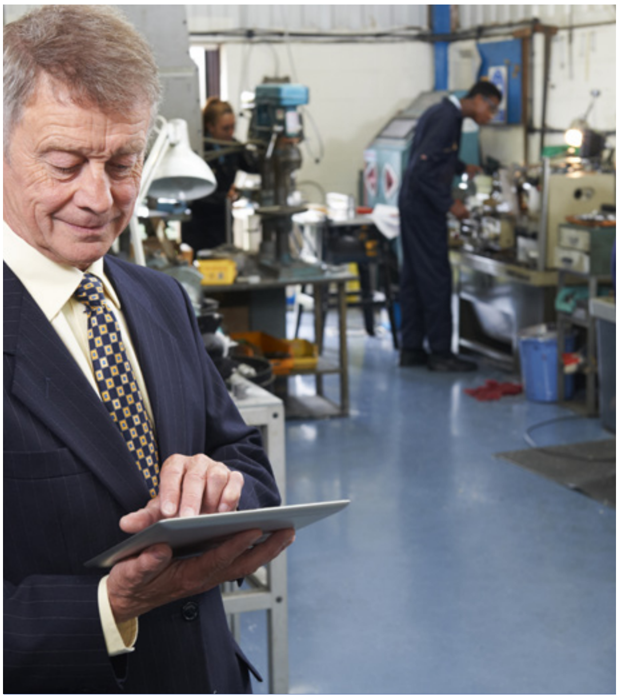
Sample term sheet

The below offers a broad overview of key components a borrower may encounter in a private credit loan agreement.

Borrower	Borrowers includes all group companies which may need access to the loan or the working capital element. Consideration should also be given including target companies being acquired with the funds provided.
Guarantors	Guarantors includes the borrower group or company and all operating subsidiaries of the company.
Obligors	Obligors includes all legal parties who owe or undertake an obligation to another through the loan contract.
Purpose	A borrower must disclose the purpose for which the business intends to deploy the financing provided.
Maturity	This designates the length of time after which the borrower must return the principal loan amount.
Ranking	As noted in the capital stack, each loan held by a business is ordered in priority of seniority in terms of repayments and access to assets.
Margin / Interest	The margin denotes the extra percentage rate of interest charged by lenders over the relevant basis rate reflecting the credit quality of the borrower. Most interest rates in loan contracts are set on the basis of LIBOR. However, LIBOR is currently being phased out by macroprudential regulators and replaced by SONIA (see Appendix).
Cash Sweep	A cash sweep mandates the borrower to use any excess free cash flows to pay outstanding debt rather than distribute it to shareholders.
Security	In secured lending arrangements, a lender requires a 'security' or collateral for cases in which the borrower may be unable to repay the loan. Such securities may include: First-ranking pledge over the shares in the borrower; First-ranking fixed and floating security over all the assets and undertakings of the borrower and its subsidiaries; and Guarantees from each of the holding companies of the borrower and their respective subsidiaries subject to confirmation of structure.
Voting	Should a borrower hold multiple loans with separate lenders, voting arrangements determine what amendments may be made to the loan agreement with the consent of only one lender, and which require the agreement of other lenders to the business.
Governing Law / Jurisdiction	The governing law is the law of the jurisdiction in which the loan will be agreed. Often the parties select the jurisdiction where the lender resides.

What happens after I receive the loan?

Once a loan has been extended, a borrower's relationship with the private credit firm does not end. In fact, the firm's investment professionals should engage in regular dialogue with company management to monitor performance. There are several ways for lenders to continue monitoring the credit during the tenure of the loan.



Covenants

During the due diligence and loan origination process, appropriate loan covenants will have been agreed in the document. Loan covenants are often incorporated into loan agreements to allow the lenders to exercise additional control over the borrowers in times of stress or poor performance, with the aim of minimising any losses to the fund. Examples include:

- **Reporting covenants** in the credit agreement which require the borrower to provide regular certified financial information, notice requirements for material events, litigation and defaults. The frequency of ongoing monitoring should be agreed in advance.
- **Financial analysis** in conducting the monitoring of the borrower, a lender will engage in an analysis of financial statements, as it serves as an early indicator of changes in a borrower's risk profile.
- **Inspection rights** granted to the lenders in the credit agreement with respect to locations, books and records.
- **Review of collateral** through field examinations to assess potential value erosion.
- **Annual certifications** by the borrower as to no defaults that require a borrower to review its operations.
- Right to take a **board observer seat**.

What happens if I cannot pay back my loan?

If a borrower undergoes periods of stress or challenging circumstances, it is in the private credit manager’s best interest to work with the business to find an effective solution.

This will typically involve working with the borrower to understand the situation and identify how best to get back on track. Such measures are tailored to the unique circumstances of each borrower but can range from enhanced monitoring, offering temporary forbearance or developing a new business plan. The following sections provide further detail on what such steps may look like.

Enhanced monitoring

If a heightened risk of default is revealed during routine monitoring, the private credit manager will place the borrower on its watchlist. Often this is due to adverse operating trends, ill-proportioned balance sheets, or adverse economic or market conditions. Non-financial considerations may also include management issues, pending litigation or other material structural weaknesses. For the borrower this means that the private credit partner will likely request more frequent access to financial information and other monitoring tools.

What does forbearance look like?

Forbearance refers to instances where a lender conditionally agrees to refrain for a limited time (the forbearance period) from exercising its rights under a defaulted loan agreement while the borrower seeks to refinance, restructure or otherwise repay its debts. A forbearance agreement often requires the borrower to make certain concessions and undertake new actions. This may include adopting substantive amendments to the loan documents that go into effect immediately and guide how the credit facility will operate during the forbearance period.

The main benefit of this approach is to give a borrower more time to meet its obligations under the loan agreement. In instances where the borrower is facing a temporary period of stress but its long-term creditworthiness remains strong, this approach can allow the borrower to ride out this period of stress whilst ultimately meeting the terms of the credit agreement.

Forbearance measures could include:

- Entering into a standstill agreement with the borrower to alleviate any immediate insolvency concerns;
- The private credit manager working with the borrower to develop a remedial or recovery plan;
- Securing alternative sources of funding;
- Payment holidays / moratorium on interest;
- Payment holidays / moratorium on principal;
- Conversion of cash payments to PIK;
- Principal reduction; and
- Debt / equity swaps or similar restructurings.

What happens in the event of default?

In circumstances where all measures implemented to assist a business with managing its adverse conditions may not be working or are proving more challenging, it may be appropriate for the private credit manager to exert more control. The degree and method by which such control may be exercised can vary. Examples could include taking an active role in the borrower negotiations with their suppliers or customers. Where appropriate, a private credit manager may also use the powers under the loan agreement to appoint lender representatives to the borrower's governing body to support the proposed rescue measures.

As a final measure, the private credit manager, like any lender, may seize the collateral provided by the borrower. However, a firm will explore all other possibilities before doing so, as a defaulting business is not in the interest of any reputable private credit firm which will seek to prevent this undesirable outcome.

Conclusion

SMEs and mid-market businesses will always be central to the success of the UK economy. This 'Borrowers Guide to Private Credit' provides these vital businesses with an introduction to the financing alternatives that are available to them. This will support their ability to invest, grow and support job creation.

This guide has demonstrated how private credit managers are well-established providers of finance that are ideally suited to supporting UK Businesses, and provided SMEs with insight into what to expect when partnering with them.

It is our hope that this guide will support the expansion of private credit in the UK and its role supporting growth and innovation by UK businesses.

How to get in touch with a private credit lender

The UK is home to variety of private credit lenders catering to different business sectors and sizes.

CLICK HERE

to contact the private credit firm of your choice to discuss next steps today.

Appendix

Acknowledgements

Yasmin Bou Hamze
Associate, Private Credit, ACC

Nicholas Smith
Director, Private Credit, ACC

Appendix

Glossary of Terms	
Arrangement fee	An arranger is typically a bank or other financial institution responsible for originating a syndicated loan. The small fee charged to the borrower is the arrangement fee.
Baskets	**Baskets** refers to negotiated exceptions to the loan agreement's prohibition on restricted payments. Baskets are either capped or scalable (allowing it to fluctuate with EBITDA).[v]
	General restricted payment basket: In its simplest form, a restricted payments covenant in a loan agreement limits the borrower's ability to make payments such as dividends, distributions, equity redemptions and repurchases to its equity holders. The provision ensures that equity holders are not paid before the loans are repaid, apart from limited exceptions. Other types of payments to parties that are not equity holders may also be covered in a restricted payments provision, such as payments to holders of the borrower's subordinated debt.
	Ratio debt basket: A ratio debt basket typically allows the borrower to incur debt secured on a senior secured basis subject to a maximum senior secured leverage ratio, and unsecured debt subject to a maximum total leverage ratio.
	Available amount starter baskets: In a building basket (or ratio-based basket), a "starter amount" is sometimes made available which permits the borrower to make restricted payments up to a fixed dollar amount even before the basket has begun to build (or without meeting the financial ratio test).

Glossary of Terms

Borrower	Borrower in the context of a loan agreement should encompass all group companies which require access to the loan. This should include any target companies which the borrower may intend to acquire with the funds provided.
Certain funds period	Certain funds provisions are required when the loan proceeds may be used to fund an acquisition governed by the City Code on Takeovers and Mergers. The provision obliges funding to be provided to the borrower in order to complete the cash payment of an acquisition within a specified amount of time. The certain funds period is typically set at four to six months from the signing of a loan agreement.[vi]
Clean down	A clean down is a provision applicable to a working capital or overdraft facility to ensure that the borrower is not using that facility as long-term debt. Such a clause will specify that the working capital or overdraft facility must be undrawn for a specified number of consecutive days in each of the borrower's financial years or other specified period.[vii]
Closing leverage	Closing leverage describes the ratio of funded debt as of the closing date to closing date EBITDA.
Commitment / ticking fees	A commitment fee refers to the fee charged by a lender to a borrower as compensation for its commitment to lend, since the lender has set aside the corresponding funds for the borrower but is not yet earning interest. Thus, such fees typically are associated with unused credit lines or undisbursed loans.
Cross default threshold	Cross default thresholds are in place to mitigate risks associated with lending money to businesses who have also borrowed from other lenders. A default in the payment of other loans of the borrower or of any member of the borrower group would also trigger a default under the second loan agreement containing a cross default threshold provision.
Default	A loan agreement will contain a standard provision to cover the conditions under which a borrower is considered to be in default, or potential default.
Delayed draw term loan	Delayed draw term loans (DDTLs) refers to bespoke arrangements allowing borrowers to request additional funds after the initial loan term period has already ended. This extended draw period is typically offered to borrowers with good credit ratings.

Glossary of Terms

Equity cure / EBITDA cures	Providing 'cures' refers to private equity sponsors injecting additional funds into a borrower in which it owns equity, in order to enable the business to meet its financial covenant test when it otherwise would not have. As cures should not be used to mask an underlying problem with the borrower's business but rather to address a short-term performance dip, loan agreements typically contain limitations on the cure right. The most common limitation on cure rights is a hard cap on both the total number of times a cure right can be exercised during the life of the loan, and the maximum permitted frequency of such cure.
Excess cash flow sweeps	A cash sweep obliges the borrower to use excess free cash flows to settle outstanding debts to lenders. Therefore, the excess cash cannot be distributed to shareholders.
Governing law	The governing law is the law of the jurisdiction in which the loan will be agreed. Typically, the lender's resident jurisdiction is selected.
Incremental facilities 'Accordion' feature	Under incremental facilities, borrowers can request for an existing loan to be increased, or that a new loan be provided under its existing loan agreement at any point in the future. This increased loan will still rely on existing collateral. **Free and clear basket**: This sets out the amount of incremental facility loans that a borrower may draw upon without having to demonstrate renewed compliance with a financial ratio test. It will either be 'hard capped' at a set amount, or can be 'soft capped' as a percentage of EBITDA. **Ratio test**: This allows the borrower to utilise incremental facilities in excess of the free and clear basket, provided that the borrower's leverage ratio or other financial ration remains below a fixed level. **"No worse off"** concept has often been included, which enables the borrower to incur the additional debt so long as its leverage ratio would not increase as a result (irrespective of how high its resulting leverage ratio is in absolute terms).[viii]
London Interbank Offered Rate (LIBOR)	LIBOR, which stands for London Interbank Offered Rate, serves as a globally accepted key benchmark interest rate that indicates borrowing costs between banks. Most interest rates in loan contracts have been set on the basis of LIBOR. LIBOR is currently being phased out by macroprudential regulators and replaced by alternative benchmarks such as SONIA and SOFR (see below).
Margin	The margin refers to the additional percentage rate of interest charged by lenders over the relevant basis rate. This typically reflects the credit quality of the borrower and will be adjusted to the relative risk inherent to the loan provided.

Glossary of Terms

Material adverse effect	Material adverse effect is used to define the seriousness of an event which may determine when the lender will request a borrower to remedy a breach of the agreement or take action on a default. Typically, this encompasses any event or change in circumstance that would significantly affect the assets, liabilities or cash flow of the borrower in a negative manner.
Most favoured nation	If an incremental facility provision is included in a loan agreement, a 'most-favoured-nation' clause (MFN) will often be found. The primary purpose of an MFN is to protect the value of the initial debt in the secondary market. By allowing the borrower to incur additional pari passu debt under the same loan agreement, the lenders run the risk that the terms of that additional debt are less favourable than the original, which will make the existing loans harder to sell on the secondary market. The solution for the lender is to allow incremental facilities to be put in place but only if certain key terms of the incremental facility fall within set parameters. This will prevent the incremental facility from being significantly more attractive to lenders than the existing facilities. Such parameters may include: The **yield** payable on the incremental facility cannot be more than the yield on the existing facility by more than a certain buffer amount. The **maturity date** for the incremental facility cannot be earlier than a specified date. There can be **no amortisation** of the incremental facility (or, if there is amortisation of the existing facilities, the weighted average life to maturity of the incremental facility must not be shorter than the existing facility). It is now increasingly common for any MFN provisions to include a sunset period of 6 to 24 months following which such pricing limitations will cease to apply.[ix]
Mitigation	Mitigation refers to a provision which obliges the lender to take into account and mitigate the effect of any circumstances giving rise to increased costs.
Origination fee	An origination fee refers to the initial fee charged by a lender for processing a new loan application, as compensation for putting the loan in place.
Pari passu	Pari passu is a Latin term that means 'on equal footing' or 'ranking equally'. If a business's debts are pari passu, they are all ranked equally, so the borrower would pay each lender the same amount in insolvency.

Glossary of Terms

Participation fee / Front end fee	Participation fees or front end fees refer to fees paid to the lender upon signing the loan agreement, at the beginning of the loan transaction.
Payment	The price of a loan is comprised of the interest rate margin which will be set out in the private credit offer letter and term sheet, and is calculated on the basis of the relative riskiness of the loan. There are several options for the method of repayment: **Specific periodic amounts:** The borrower will make a specified payment to the lender at regular intervals. **Bullet loan / Lump sum payment:** The borrower pays nothing to the lender until the end of the note term, at which time the borrower repays the entire note in one payment. **Interest only:** The borrower makes regular payments to the lender that are put towards paying off the interest on the principal amount only, with no portion of the payment going towards the principal amount itself. **Interest and principal:** The borrower makes regular payments to the lender that are put towards paying off both the principal amount and the interest as it is compounded. At the end of the term of the loan agreement, there will be no outstanding balance to be repaid. **Payment in Kind (PIK):** A credit arrangement whereby interest is not paid on borrowings in cash between the funding date and maturity of the debt product, but instead is added to the principal balance of the loan. **Voluntary prepayment** means a prepayment of principal to the extent that such prepayment reduces the scheduled instalments. Voluntary prepayment is only possible if stipulated in the loan agreement.
Permitteds	Loan agreements typically seek to accommodate the need for operational flexibility by allowing for certain categories of "leakage" to be permitted. Thus, a loan agreement usually contains a specified list of permitted exceptions from the covenants that prohibits the borrower from making restricted payments. These Permitteds typically fall within three broad categories: Market-standard and universally accepted as being necessary in order for any business to operate effectively; Business-specific and are accepted by the lenders on the basis that they are justifiable leakages; or Broad general baskets (see Baskets) for leakages not falling within a specific permitted under the first two categories but with which lenders are comfortable.[x]

Glossary of Terms

Portability	A portable loan is debt for which a change in control of the business would not trigger the early repayment of the debt.
Pro forma	Pro forma, a Latin term meaning 'as a matter of form', refers to the process of presenting financial projections for a specific time period in a standardised format to allow for comparison and analysis.
Revolving credit facility margin	A revolving loan is a flexible financing tool allowing for repayment and re-borrowing of the funds. A revolving credit facility margin provides the borrower with the ability to withdraw funds, repay, and withdraw again.
Secured Overnight Financing Rate (SOFR)	The secured overnight financing rate, or SOFR, is an interest rate that banks use to price U.S. dollar-denominated derivatives and loans. The daily SOFR is based on transactions in the Treasury repurchase market, where investors offer banks overnight loans backed by their bond assets. SOFR has been published since April 2018 as part of the process to replace LIBOR.
Step downs on margin ratchet	The margin ratchet is a mechanism whereby the initial margin interest rate a lender charges can be reduced if the borrower achieves a better financial position. If that financial position subsequently worsens, the margin will return to its original level.[xi]
Sterling Overnight Indexed Average (SONIA)	The Sterling Overnight Indexed Average (SONIA) measures the rate paid by banks on overnight funds. It is calculated as a trimmed mean of rates paid on overnight unsecured wholesale funds.
Unrestricted and restricted subsidiaries	A typical covenant package will limit a corporate group from taking certain actions by applying restrictions to a borrower and its 'restricted subsidiaries'. By default, all subsidiaries of the borrower will be part of the restricted group unless they are specifically designated as 'unrestricted'. The purpose of these provisions is to avoid a 'leakage' of collateral, meaning the transfer of the assets of a business to a subsidiary which is not included in the initial loan agreement.

Endnotes

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About the ACC

The Alternative Credit Council (ACC) is the global body representing asset management firms in the private credit and direct lending space. It currently represents over 200 members that manage $450bn of private credit assets. The ACC is an affiliate of AIMA (the Alternative Investment Management Association). It is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy. They finance mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure and the trade and receivables business. The ACC provides guidance on policy and regulatory matters, supports wider advocacy and educational efforts and produces industry research to strengthen the sector's sustainability and economic and financial benefits. Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

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About AIMA

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 200 members that manage $450bn of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

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