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Private Funds Update

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Tour De Private Credit: BeSPOKE Private Loan Securitizations Gain Traction

With the turbulent macroeconomic climate, we have seen increased growth over the past couple of years in alternative private credit financing structures. In particular, there has been an upswing in private, bespoke securitization structures similar to private credit collateralized loan obligation (CLO) transactions, and we have advised on a number of these transactions recently for both asset managers and investors. While there is often confusion in the market with respect to the nomenclature of what exactly to call these transactions, we refer to them as Private Loan Securitizations or "PLS" transactions. In the private credit space, PLS transactions are a growing and viable alternative for asset managers of all sizes, but particularly for those asset managers who do not yet have the size and scale to undertake a syndicated CLO transaction. PLS transactions also present an opportunity for investors to work closely with a specific asset manager to create a tailored product that is well suited to each party's needs. This column is a brief introduction to these transactions and how they can be utilized.

What Is the Basic Structure?

In a PLS transaction, the issuer is usually a bankruptcy-remote entity that acquires a pool of corporate loans that it finances through the issuance of tranches of rated notes and an "equity tranche," which is often in the form of subordinated notes. Although each PLS transaction is bespoke, these transactions are structurally similar to CLOs. However, they draw inspiration from certain features more commonly seen in private funds.

Who Would Find a PLS Attractive?

PLS transactions have come about as a way to satisfy unique needs coming from the manager side, or investor side, or both.

Manager side. PLS transactions provide a valuable entry point for asset managers looking for a capital markets style securitization but who have not otherwise sponsored a broadly syndicated securitization. Functionally, a PLS can be managed alongside a manager's current private fund(s) from an origination perspective and thus help facilitate overall platform growth and origination capabilities.

Investor Side. PLSs need not be solely employed by smaller or newer issuers. In fact, we have seen a number of these transactions involving a large asset manager and a strategically-important relationship investor which desired a tailored securitization product. Finally, these structures are also attractive for regulated investors subject to risk-based capital requirements, as holding rated notes issued in a PLS offers better capital treatment than direct exposure to the underlying assets.

How Are PLSs Similar to Regular Private Credit CLOs and Private Funds and How Are They Different?

Some of the key considerations for parties when arranging a PLS transaction include:

- **Quasi-Private Fund Features.** PLS transactions frequently borrow structural features from private funds.
  - *More Gradual Capital Deployment*: As in a private fund, it is common for PLS transactions to be structured to permit multiple closings in which additional capital is drawn down with each closing, as opposed to a traditional CLO, in which all capital is drawn down at closing. This can allow for a more efficient upsizing of the PLS. In addition, the notes issued in a PLS are often issued in the form of delayed draw notes so as to permit funding from investors over an extended timeline. Fundings are made in accordance with a priority of funding to ensure that the target capitalization of each tranche of debt is maintained. These features provide for greater flexibility and a longer timeline to fully ramp the transaction.
  - *Limited transferability*: The rated notes issued by the vehicle typically have limited transferability and require the consent of the asset manager in order to be transferred to another holder. Although this is a negotiable point, the manager having such consent rights provides a measure of security that the investor composition of the PLS will remain known to the manager; this is a particularly important point in a delayed draw note structure where the creditworthiness of the investors will be scrutinized by both the rating agency and the asset manager.
  - *Defaulting Holder Provisions*: Unlike a typical CLO, a PLS transaction wherein the note holders are expected to advance funds on multiple dates generally includes defaulting holder provisions in case a holder fails to fund. These provisions are usually heavily negotiated among investors and the asset manager. Some potential consequences as a result of not funding and becoming a defaulting holder include diversion of payments of interest and principal owed to such holder until they are no longer a defaulting holder and/or the issuer requiring such holder to transfer its notes and unfunded commitments to a replacement holder. These provisions provide peace of mind to both the asset manager and the other investors, given the potentially chaotic consequences if a holder fails to fund an advance.
- **Rating Agency Considerations.** Different rating agencies use different methodologies for evaluation. We have found that most PLS transactions have been rated by either DBRS Morningstar or Kroll Bond Rating Agency. As PLS transactions pull from both CLOs and private funds in order to create flexibility while also creating leverage, the senior most tranche of debt typically will receive a "AA" or "A" rating. It is worth noting though that theoretically a "AAA" rating is obtainable, subject to stripping away some elements of flexibility in the structure.

  Given the varying levels of scrutiny the rating agencies apply to these transactions as compared to a syndicated CLO, there are certain deal features that may be included which you would not typically find in a CLO, including the ability for the issuer to purchase equity securities and an extended ramp-up period.
- **Investor Stipulations.** While the volume of investor stipulations received in a PLS transaction is generally lower than one would receive

in a syndicated CLO, given the bespoke nature of these transaction, the structuring of the transaction is overall a more comprehensive dialogue of back-and-forth with investors, more akin to a bilateral facility and/or negotiation around a private fund formation.

- **Underlying Collateral.** The CLO technology applied to PLS transactions can be applied to assets in private credit beyond just corporate loans, including, for instance, infrastructure related credit and aviation CLOs (which typically include loans to airlines and loans secured by pools of aircrafts). As private credit generally expands, we would not be surprised to see PLSs utilized for a variety of underlying assets given the importance of the securitization markets generally to such expansion.

Is It a PLS or Rated Fund?

PLS transactions are often confused with rated-note fund transactions (Rated Funds). Both transactions provide better capital treatment for regulated investors subject to risk-based capital requirements by investing in a rated debt instrument as compared to a standard limited partnership investment of a private fund. Also, as noted above, many features of PLS transactions are structured similarly to private funds. However, there are some key differences.

- Rated Funds are not securitizations, and the notes issued by such funds are usually unsecured. In contrast, the notes issued in a PLS are backed by a security interest in the pool of collateral owned by the issuer and managed by the asset manager.
- Rated Funds are less often operated for providing leverage, while PLSs are intended to be used for leveraging purposes and provide a levered return on the rated-notes. PLSs are actively managed, on-balance sheet transactions used to finance a pool of assets with the goal of increasing their equity investor returns. Whereas Rated Funds might take out a separate leverage facility on top to finance it, the PLS transaction is the financing itself and opens up opportunities for alternative investors that seek exposure to securitization investments.
- Upon full funding of the notes, a PLS transaction should theoretically offer greater liquidity in the market for investors as compared to Rated Funds as there is a fairly established secondary-market for CLO-like products.

Outlook

The outlook for PLS transactions appears promising. In a challenging market, these transactions offer asset managers of private credit more flexibility and creativity to raise capital than a typical structured product like a standard middle market CLO. They also are attractive to investors seeking higher interest rates than those offered in more traditional securitizations and a product tailored to fit specific investment criteria. As such, we expect to continue to see increased interest in PLS transactions in the private credit space.

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