

## **The lucrative AI debt market – disrupting traditional debt lending (Part 1)**

### **IS TRADITIONAL DEBT FINANCING APPROPRIATE FOR AI COMPANIES?**

The recent surge in AI development has prompted some of the largest financial institutions to extend billions of dollars in debt to AI companies, driven by the expectation that they will generate significant revenue in the future. However, this raises the question of whether traditional debt financing should be extended to AI companies in such a manner.

An AI company is one that generally leverages algorithms and vast amounts of data to create systems that perform tasks that typically require human intelligence, such as natural language processing, image and speech recognition, predictive analytics, and autonomous decision-making. The unique nature of its revenue generation models and its assets, such as proprietary algorithms, data sets, and other intellectual property (“IP”), distinguishes an AI company from a traditional business and presents both opportunities and challenges in the context of traditional financial lending.

Traditional lending frameworks typically rely on financial covenants to help lenders identify signs of financial difficulty within a borrower before an actual default occurs, providing the earliest possible opportunity for intervention. Such lending frameworks were originally designed in a pre-AI age, for industries that were more predictable and stable. If the current demand for AI retracts or does not rise as significantly as predicted, the fluctuating nature of AI businesses—due to rapid technological advancements and market volatility—could present distinct challenges to the process of creating an objective and measurable framework for the lender to monitor the AI company's financial health if traditional lending frameworks are not properly considered in the context of such companies.

In the first section of this article, we explore the role of several financial covenants in traditional lending frameworks. In the second section of this article, we examine how the rapid shifts in the AI sector pose challenges in setting and monitoring these covenants for AI companies. While we do suggest ways in which financial covenants could be adapted to become more effective for AI companies generally, it is essential to seek professional legal advice when lending to an AI company in order to get advice specific to the needs and characteristics of that AI company.

### **FINANCIAL COVENANTS**

Financial covenants are promises given by a borrower to a lender to meet or comply with certain financial thresholds tailored to the borrower's unique circumstances. These covenants serve as an objective and measurable framework for the lender to uphold and monitor the borrower's financial health. A primary purpose is to provide early warning signs of financial distress, allowing the lender to intervene and protect its interests before the borrower defaults on payment obligations.

Financial covenants can be assessed continuously throughout the term of a loan or at regular intervals, typically half-yearly or quarterly. If a financial covenant is breached, the lender usually has the right to declare an event of default, which may give the lender, among other things, the right to accelerate the loan (demand early repayment) or enforce security.

We will delve into the role of several financial covenants within traditional lending frameworks. It is important to note that not all covenants are used simultaneously, especially in mainstream lending scenarios. The selection of covenants depends on the specific context of each transaction.

#### **Minimum net worth**

Lenders use this financial covenant to assess the value of the borrower's assets and how easily the borrower could access valuable assets to meet its payment obligations if there was a squeeze on cashflow. Lenders will want the borrower's net worth to be based on assets which represent quantifiable or realisable value in the business, which is usually its tangible assets over intangible assets.

For AI companies, however, intangible assets that are critical to the AI company's operations may need to be included, such as IP and proprietary software. This will require lenders to establish clear guidelines for valuing IP and software assets. This could involve third-party valuations and considering the potential for future revenue generation from these assets. However, while including intangible assets

like IP and software is essential for AI companies, lenders should ensure these assets are valued conservatively and regularly reassessed to reflect their true market value.

### **Gearing ratio**

The gearing ratio compares the borrower's indebtedness with its net worth. Lenders use this financial covenant to assess how reliant the borrower is on debt and monitor whether or not there are sufficient assets in the borrower to get the full amount due on enforcement, if need be. It will either be drafted as:

*"Gearing ratio means the ratio of total borrowings to net worth" (as a ratio) or "Total borrowings will not exceed X% of net worth" (as a percentage)*

### **Loan to value ("LTV") covenants**

LTV covenants require that the principal sum outstanding on a loan, when expressed as a percentage of the value of the security charged to a lender, to remain below a stipulated level during the term of that loan so that the lender can recover the amounts due on security enforcement, if need be. It will be expressed as:

*"The Borrower shall procure that the amount of the Loan shall not at any time exceed 80% of the Market Value [of the Security] according to the most recent Valuation"*

While more common in real estate, LTV covenants can be adapted to AI companies by using the value of key assets, such as IP or proprietary technology, as security.

### **Leverage ratio**

The leverage ratio compares borrower's indebtedness with its profits. Lenders use this financial covenant to assess whether the borrower is making sufficient profits to service its debt. The leverage ratio is typically expressed as the ratio of:

*"Total [net] debt to EBITDA (earnings before interest, tax, depreciation and amortisation)"*

where EBITDA is the profit element of the test. AI companies employ various business models and strategies to generate revenue and, in the context of lending to an AI company, the EBITDA definition will need to be adjusted carefully to reflect the specific earnings structure of the AI company. For example:

1. *Software as a Service (SaaS):* AI software offered on a subscription basis.
2. *Licensing:* Technology licensed to other businesses. This can include licensing AI algorithms, models, or entire platforms. Such licensing agreements can be structured as one-time fees, recurring royalties, or a combination of both.
3. *Consulting and professional services:* Services to help businesses implement and optimise AI solutions. This can include custom AI development, integration with existing systems, data analysis, and training. Revenue is generated through project-based fees or hourly rates.
4. *Data monetisation:* Revenue by collecting and analysing large datasets, then selling insights or access to the data.
5. *Product sales:* Revenue from selling AI hardware.

### **Fixed charge cover ratio**

The fixed charge cover ratio, also known as the cashflow cover ratio, tests whether the borrower's cashflow is sufficient to meet its debt obligations. Cashflow will be calculated by adjusting EBITDA to deduct amounts included in EBITDA that are non-cash items (such as capital expenditure) and to add cash items that are not included in EBITDA (such as disposal proceeds). It will be expressed as:

### *Cashflow (Adj. EBITDA): Debt Service*

Given the diverse revenue models of AI companies, lenders should work closely with borrowers to define EBITDA adjustments that accurately reflect the company's financial health. This might include adjustments for R&D expenses, which are typically high in AI companies but important for long-term growth.

### **Interest cover ratio**

The interest cover ratio tests whether the borrower's earnings are sufficient to cover interest payments. It will be expressed as:

$$\text{EBITDA: Finance Charges (the interest and fees due on borrowing)}$$

## **PROBLEMS WITH USING FINANCIAL COVENANTS TO MONITOR AI COMPANIES**

The rapid evolution of the AI sector presents challenges in establishing and monitoring financial covenants for AI companies. Although these challenges are not exclusive to AI companies and also affect technology companies more broadly, they are particularly pronounced for AI companies due to the current surge in demand for AI technologies and the relatively young age of many AI companies as compared to traditional technology companies. This section explores how the rapid shifts in the AI sector could complicate the setting and monitoring of financial covenants for AI companies.

### **Valuation challenges**

The minimum net worth, gearing ratio, and LTV covenants all hinge on the accurate valuation of an AI company's assets, a task that is inherently complex due to the intangible nature of many AI-related assets, such as its IP and proprietary technology. The rapid pace of technological advancements and market factors may also cause fluctuations in asset values, making it difficult to establish a stable basis for monitoring the financial health of AI companies. This issue will be explored in greater detail in Part 2 which looks at security.

### **Revenue volatility**

The leverage ratio, fixed charge coverage ratio, and interest cover ratio all depend on stable revenue streams to provide an accurate assessment of an AI company's financial health. However, AI companies often experience significant revenue volatility due to the nascent and rapidly evolving nature of the industry. For instance, while AI companies may secure large contracts and projects, these can be irregular and unpredictable. Additionally, revenue fluctuations can arise from intense market competition and rapid technological changes. AI companies also typically undergo cycles of heavy investment followed by periods of revenue growth, further contributing to revenue instability.

Given these dynamics, traditional covenants that rely on stable revenue streams may not be suitable for AI companies, as they could frequently breach these covenants during periods of low revenue. To address this, it could be necessary to incorporate flexibility into these covenants to account for revenue fluctuations before they are considered breached.

For example, annual recurring revenue (ARR) covenants are becoming increasingly popular for businesses without positive or substantial EBITDA, such as emerging stage companies. These covenants use debt:ARR as a reporting metric instead of debt:EBITDA to access leveraged debt, where ARR is typically based on multiples of annualised recurring revenue. Many such covenants are structured to transition to an EBITDA-based leverage model as the company matures and begins to generate positive EBITDA. These covenants are typically accompanied by a minimum liquidity covenant testing the sum of cash and available working capital facilities tested monthly, rather than quarterly.

Alternatively, under bespoke drafting for such a financing, an event of default could be defined to occur only if a breach of the covenant continues for two successive quarters. The borrower would then need to demonstrate compliance with the covenants for two successive quarters thereafter to remedy the breach and confirm that the initial breach was a one-off occurrence. On the other hand, lenders might consider using a rolling average of EBITDA over several periods to smooth out fluctuations and provide

a more stable basis for assessment. Additionally, incorporating "cure periods" or "equity cure rights" could allow the borrower to rectify covenant breaches by injecting additional equity or other forms of capital within a specified period.

### **Rapid technological changes**

The AI industry is characterised by rapid technological advancements, which could result in shifts in business models and strategies. For instance, an AI company might transition from a product-based model to a service-based model. Traditional financial covenants, such as the leverage ratio, fixed charge coverage ratio, and interest cover ratio, typically rely on fixed definitions of revenue generation. These covenants may not be flexible enough to accommodate changes in business models and strategies, leading to potential breaches and the need for renegotiations.

To address this, financial covenants could be drafted with flexibility. This can be done by incorporating adjustable definitions and thresholds that account for these changes in revenue generation methods. For example, covenants could include provisions for periodic reviews and adjustments based on the company's evolving business model, allowing for recalibration of metrics like the leverage ratio, fixed charge coverage ratio, and interest cover ratio.

Additionally, incorporating performance-based metrics that align with the company's strategic goals, such as key performance indicators (KPIs) related to product launches or certain technological advancements, rather than rigid financial ratios, can provide a more accurate reflection of the company's financial health. This approach ensures that covenants remain relevant and enforceable, reducing the likelihood of breaches and the need for frequent renegotiations.

### **Limited historical data**

Many AI companies are relatively new and do not have extensive historical financial data. This makes it difficult for lenders to accurately assess the company's financial health and performance to set appropriate covenant levels. This results in covenant thresholds that are either overly stringent or lenient, which reduces the effectiveness of financial covenants entirely to monitor the company's financial stability.

To address this, lenders could adopt forward projection models to establish covenant levels. These models use predictive analytics and machine learning algorithms to forecast future financial performance based on current data, market trends, and industry benchmarks. Although this approach carries inherent risks due to the reliance on projections rather than historical performance, it would incorporate a range of scenarios and stress tests that would enable lenders to create more appropriate covenant thresholds.

Alternatively, to alleviate the need to set thresholds entirely, lenders could also consider adopting "covenant light" structures that have fewer financial maintenance covenants and fewer restrictions on the borrower. This approach allows AI companies to operate with greater flexibility and invest in growth opportunities without the constant pressure of having to meet restrictive financial metrics. Lender oversight could then be done through other mechanisms, such as regular performance reviews and strategic discussions with the company's management.

### **CONCLUSION**

While extending debt financing to AI companies presents significant opportunities, it also introduces unique challenges that traditional lending frameworks may not adequately address. Financial covenants tailored to AI companies should account for the valuation complexities of AI-related assets and revenue volatility associated with the AI industry. If lenders are to continue lending to AI companies, they must adopt innovative and flexible approaches to financial covenants to effectively manage the risks associated with lending to AI companies. Given the complexity of these issues, it is crucial to seek expert legal advice to mitigate against potential risks.