Subscription Lines and Other Fund Lending facilities

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The following are my notes collected over several years of working with subscription lines within alternative assets. While not always the most critical issue, understanding sub lines and other lending facilities can help improve LP fund governance, performance reporting, and enable the LP to ask better questions during due diligence and throughout the fund life.

Overview

- Subscription lines are not a new phenomenon in private markets as they’ve been used for decades. They allow managers to borrow to fund bridge financings and then eventually call the capital from limited partners
- The ability to delay calling capital enhances the manager’s flexibility to execute deals and shortens the J-curve, enhancing the fund’s Internal Rate of Return (IRR), particularly early in a fund’s life, and therefore its competitiveness on a quartile basis
    - Funds use credit lines to boost Net IRR's and accelerate carried interest, particularly in funds with European style waterfalls
- From an LP perspective, the use of these lines helps smooth cash flows and eases the administrative burden of responding to capital calls.
    - Improves capital call logistics – small investment outlays more conveniently aggregated
- Can be utilized to fund partnership expenses and management fees
- May be used to guarantee portfolio company obligations to the seller/buyer
- Sub lines have evolved from a short-term bridge financing tool to a broader tool to manage the cashflows and performance of the fund
- Note, ultimately carried interest is lower when using the sub line than without because of the interest cost
    - Reduced profits leads to less absolute dollars for both the GP and LP

Underwriting

- Based almost entirely on LP creditworthiness
  - Reputation of sponsor is less important
  - Agnostic towards the assets/investments
- There are other facilities that do care about underlying assets – stretch facilities used near the end of the fund's life; hybrid and NAV facilities (discussed later)
- Full recourse loan to the fund – fund is obligated to repay even if collateral is insufficient
- Almost all subscription facilities are committed facilities – lender is obligated to make the loan
- Always a revolving facility; rarely do you see term sub facilities
- Sub facilities must be explicitly authorized by LPA
- An LP is only obligated to their capital commitment; LP doesn't have to provide other credit enhancement to the lender

Borrowing Base

- Lender will make an advance up to the borrowing base – percent of the fund's uncalled capital commitments; max size of the loan is always less than available capital call amount
  - As capital is called, uncalled capital commitments decrease and therefore lower the borrowing base
  - Doesn't expand purchasing power like traditional leverage
- Borrowing base – 90% for rated institutions (public pension); 65% for unrated institutions – Family Office, HNW investors
- There are concentration limits limiting the borrowing base attributable to a single LP
  - Can be 15% for highly rated institutions; 1% for non-rated institutions or HNW investors
- Will exclude certain investors from borrowing base; but ALL investors are in the collateral base
- Lenders will use shadow ratings – for example, will use corporate parent credit ratings as a proxy for creditworthiness of pension plan

- LPs that use an SPV provide very little information, lender will try to identify credit linkage to the parent company; but obviously there's a reason the LP formed an SPV
- There is flexibly to increase borrowing size as additional closings occur
- VC lenders typically use a flat rate: 50% of all unfunded capital commitments
- Coverage ratios: maintain uncalled capital to debt of 2:1
- Less sensitivity to underlying LP classification
- LP's will drop out of borrowing base if they file bankruptcy
  - Rare to see this happen in practice given the reliability of LPs

Collateral

- Includes the fund's right to call capital from LP, capital contributions themselves, and the collateral account
- Includes any enforcement rights
- Does not include any security interest in the fund investments or distributions

Repayment

- Subscription lines are typically repaid by capital contributions
  - One exception: a real estate fund buys a property with sub line, then takes out permanent financing and repays sub line with the loan
- If loans exceed borrowing base:
  - Haven't really seen this in practice because LPs haven't defaulted
  - Will see this if capital call goes out that reduces uncalled capital base; loan may then be over maximum and will have to be prepaid until under maximum limit

Investor Letters

- If LPA provisions are not adequate, lenders may request investor letters
- LPs give various acknowledgments, representations, and covenants to give lenders comfort of LP's ability to make good on facility
- 25 years ago, sub lines required investor letters from every LP
- Now getting investor letters is a nuisance; large movement away if investors give appropriate acknowledgments in the agreements
- Exceptions where investor letters are used:
    - If the LPA didn't adequately address sub line in a way that the lender can get comfort
    - An SMA or transactions where 1 or 2 investors have high concentration risk and lender has high exposure – lender wants additional comfort
    - Use of investor letters in prior funds
- Typical letter is structured between investor and lender so lender can issue capital call

Maturities

- Majority are 1 year
- Many GP's extend maturities beyond 1 year; sub line is less about managing capital calls and looks more like leverage
    - Need to ask GP what the intended purpose is with >1 year maturities
- 6-9 months is ideal
- Any individual loan may have earlier clean down provision
- Extensions are typically 1 year

Interest Cost

- Average 165 bps over LIBOR (3-6% all-in)
- Lowest source of financing for a fund
    - Less expensive than all other asset or investment-level debt
    - Smaller deals have higher margins
- Pristine credit performance of sub lines
- Pricing is tiered based on quality of LP investors
    - Very little information is needed from LPs
    - Lenders rely on public information
- Sub line interest is often excluded from being a capital contribution

Performance/IRR Effects

- While the use of a credit line is not going to "make or break" a fund, there are meaningful benefits to performance:
    - Typical net IRR boost of 100-300 bps
    - If equity is deferred for longer periods, the effect is greater
    - Moderate improvement in probability of achieving a standard 8% preferred return hurdle
    - The wide discretion given to the fund manager regarding when to call equity and retire debt means they can effectively manage IRR, within certain limits
    - GAAP does require the reporting of unlevered IRR's
- LPs evaluating relative benchmarked performance of GPs should take into consideration the potential impact of these lines on quartile rankings, as well as vintage year classifications tied to the dates of first net cash flows versus first investment LPs should also consider that all commercially available peer benchmark providers are very likely to include both the returns of funds with credit facilities and those without.

Risks

- Clawback Issues
    - There is the potential for the GP to receive carried interest in cases where the unlevered IRR may not meet the preferred return hurdle, but the use of the line of credit could cover the margin
    - Lowering of the hurdle may lead to clawback issues later in the life of the fund

- Liquidity Risk
    - The rapid rise of this practice has brought forward questions about cumulative institutional liquidity risk
    - LPs have raised concerns about the ability for the lender to recall the line in the case of an Event of Default (EOD) with the manager
    - In the unlikely event of a market event triggering the simultaneous calling of capital across multiple lines at once, liquidity pressures could impede an individual LPs' ability to meet accumulated larger calls as these lines mature
    - Due to the unevenness of disclosures, many LPs are not fully aware of their cumulative exposure through these facilities

- Legal Risks
    - Unchecked use of these lines poses legal risk for LPs
    - The terms of the subscription facility may grant the lender excessive discretion over decisions or assignment
    - This may extend to covenants that limit transfer rights, inhibiting GP approvals of secondary sales by "Included Investors"
    - "Included Investors" may be compelled to submit to extensive documentation and other requirements by the lender

GP Benefits

- Avoid the need for true-ups among different close investors:
  - Will hold investments on sub line until all closings are complete; then can issue one capital call
- Guaranteeing debt of portfolio company
  - Instead of portfolio company paying 10%+, the fund has portfolio company join the sub facility as an additional borrower
  - Fund will guarantee borrowing and get the debt at the fund rate - massively reduces interest cost
- Use lender for currency exchange so fund doesn't have to swap currencies
- Sub line is the working capital line – pay accounting, etc via sub line and then clear out with capital call
- For levered funds - can use sub line to create leverage until fund has built up enough assets to get asset level leverage
- Avoid financing condition in purchase document (for example, real estate – don't need to have permanent financing committed at purchase)
- Fund can use sub line to assist with hedging activity; can use capital calls and hedging program as security interest

Lender Perspectives

- Amount lent is frequently around 20% of total value or >50% of uncalled commitments of select "included investor"
- Using Sub Line for Distributions
  - Lenders don't like this and will prohibit because they want borrowed fund to go into the asset base that would be part of bankruptcy case in worst case scenario
  - Rarely happens in practice
  - Can be an option if LPs want a dividend recap
- Remedies

    - GP will issue cap call if still involved; if GP is removed, lender will issue capital call
    - Lenders can prohibit distributions to LPs until loans repaid
    - Lenders have the ability to step into GP role and pursue an LP that defaulted; almost never happens given LPs rarely default

Other Issues

- Concern regarding uncommitted facilities (gives lender discretion to fund or not)
    - Tiny portion of market
    - GP's like it because it's a little cheaper and they can always call capital if needed
- Demand feature on sub lines – lender can terminate facility with short notice (i.e. 12 days)
    - GPs stay away because they want certainty of facility
- Concern regarding umbrella facilities – collection of separate sub lines that are documented under one credit
    - Agreement with separate schedules for each fund
    - No cross collateralization or cross defaults

Key Considerations for LP's

- How will waterfall provisions be affected?
- What limits, disclosure, or approval rights should be included in LPA?
- What should be disclosed and when?
- What role should the LPAC be?
- The fund must bear interest costs related to the debt facility, which slightly lowers the net cash on cash return
- The leveraged IRR increases the probability of carried interest payments even when the return on the underlying assets was not sufficient to achieve the preferred return.
- Does the line cross-default in the event one of the LPs defaults?

- In the event that an LP whose commitment was used to secure the line needed to sell their commitment on the secondary market, how would that impact the line, the ability of the LP to sell, and the overall partnership?
- Under what circumstances, e.g., regulatory changes, could the facility be pulled by the Bank?
- Is LPAC approval required to open or extend the line? Does initiating or extending the line require any amendments to the LPA?

Recommendations for LP's

- Modify the cashflow dates for purposes of the preferred return/hurdle rate to reflect when the credit facility was drawn, not when LP capital was called.
    - LP's get compensated for the credit facility interest and fee expense that is charged to the fund
    - Within partnership agreements, waterfall provisions should specify that the date used to calculate the GP's preferred return hurdle aligns to when the credit facility is drawn, rather than when capital is ultimately called from the LPs.
- Managers are advised against using these facilities to cover fund distributions in anticipation of, but prior to, a portfolio company exit.
- LPs sitting on Advisory Committees should consider adding a discussion item on the use of credit lines to LPAC meeting agendas, potentially to include an assessment of whether the terms of facilities in use are considered "market".
- Disclosure of investment details in the underlying portfolio should not lag the execution of a deal due to capital calls delayed by use of these facilities. Reporting should be on a mutually agreed and reasonable basis, regardless of the timing of the capital call.
- Managers are encouraged to include the firm's official policy on credit lines as part of the due diligence packet provided to LPs, including the

intended use of proceeds from current or future utilization of such lines, and how the impact will be disclosed to LPs.

- During due diligence of a prospective manager, LPs should request that managers provide the impact of lines of credit on track record, i.e., levered and unlevered IRRs, as well as any tax impact.
- A maximum percentage of all uncalled capital, e.g., 15-25%. Subscription facility exposure should be considered and reported holistically, taking into account the more traditional limitations on fund borrowings for any other purpose.
    - Maximum period of time for which such lines can be utilized, aside from agreed upon parameters related to the maturity of such facilities
- Other suggested language:
    - Advance rates applied to "Included Investors" should be based on uncalled capital, rather than a fixed percentage of NAV
    - Lines should be secured only by LP commitments to the fund, not by the underlying assets of individual LPs or the invested assets of the fund. Cross-collateralization of these lines is to be avoided
- LPs may elect to consider an agreed upon cap on total interest expense payable by the partnership
    - Such provisions should also make clear the manager's responsibility to disclose the terms of the line itself to all LPs, including
- Documentation or other burdens placed on the LPs whose commitments are used to secure the line.
    - Such requirements should be limited to acknowledgements as to the LP's capital commitment, and in accordance with the partnership agreement provisions related to books and records, e.g., limited to disclosure of publicly available information, etc.
    - LPs should not be expected to make representations to the lender
    - In cases where certain LPs seek the ability to opt-out of such borrowings, confirmation of the availability of prefunding rights,

    shorter durations or similar mechanisms for exemption where requested
  - Terms of the line itself that may introduce additional risk, e.g., payable on demand, lender discretion over management decisions or exposure beyond unfunded commitments, syndication among multiple lenders, cross-default provisions

Ideal GP Disclosures

- Managers should disclose the following as part of quarterly reports:
  - The balance and percent of total outstanding uncalled capital. Such disclosures should be provided as part of a holistic reporting of the total debt/credit in use by the fund
  - The number of days outstanding of each draw down
  - The current use of the proceeds from such lines, i.e., solely to bridge capital calls (and the nature of those capital calls), or for other purposes (such as accelerated distributions)
  - Net IRR with and without the use of the credit facility
  - Terms of the line (upfront fee, drawn and undrawn fees, etc.)
  - Costs to the fund (interest and fees)

Other Lending Facilities

- GP-Level Sub lines (not to be confused with fund-level sub lines)
- NAV Facilities
- Preferred Equity
- Hybrid Facilities

GP Subscription Facilities

- These are different than fund-level sub lines
- Permits GP to act as a lender to a fund by taking out a line of credit, pledged by it's capital call rights in order to make an investment or pay fund expenses
- The limitations of a fund subscription facility are not normally applied to a GP-level subscription facility
- LP's often lack information and governance rights to know when a GP creates or uses a GP subscription facility
- No LP input on interest date and feed charged to LPs
- LP's often won't know their aggregate exposure to sub facilities
- Need to ask and verify in the fund agreements whether GP is allowed to have a sub line facility at the GP level

NAV Facilities

- NAV facilities:
    - Term or revolving facility to fund
    - Don't use capital commitments as collateral
    - Collateral based on investments, equity of holding companies, and distribution proceeds
    - Borrowing base reflects eligible investments and applicable concentration limits
- Purpose:

- Bridge realizations; if lender know they will realize an investment in the next 12-18 months, they can accelerate distributions back to LPs
    - Protect Value: asset in distress that can't be refinanced traditionally; facility provides capital
    - Build Value: towards end of investment period, sub lines are not available. GP can use NAV to do follow on investments that are otherwise unavailable
    - Lenders need to understand how funds operate and understand underlying asset base; not all lenders can do so there is a small lender base that can do NAV lending
- NAV facilities are a much smaller market than a typical sub line
- Typically used for Debt funds and Fund of Funds
    - Can’t get leverage at the investment level in these funds
    - Implemented during or after investment period
- Benefits of NAV Facilities
    - Liquidity to support portfolio companies when all capital commitments have been called
    - Availability to do follow on investments
    - Cheaper than investment-level debt

NAV Terms

- Higher interest rates than sub lines but cheaper than asset level financings and preferred equity
- More expensive with more risk for the lender
- Lenders need to understand fund risks and investments
    - Key for underwriting is the valuation
- Investment valuations are critical; focus on LTV
    - Represents actual leverage compared to a traditional sub line that does not
- Min NAV and/or max LTV covenants
    - Underscores all NAV facilities

    - As fund sells investments, the loan will amortize to keep consistent profile
- Many debt funds will do a securitization like a CLO that has very similar economic effect to a NAV facility.
- Can be current pay or PIK; see more PIK typically
    - Have longer tenor than sub lines; NAV facilities range from 3-7 years
- Implemented before or after investment period
- Borrowing base comprises eligible investment with concentration limits
- Cash sweep - as assets are realized, a portion of proceeds will be used to repay the debt; % depends on transaction quality and GP quality
- NAV's often use SPVs: fund may have sub line so SPV will segregate NAV facility from sub line
- Almost all funds will have language expressly allowing indebtedness
- There is a narrative that NAV facilities are "risky"
    - Need to think about NAV terms - 99% LTV on risky assets would be risky; no lender would ever do that
- Alternative lenders are lending in this space - insurance companies, pension funds

NAV Considerations for LP's

- Issues for LPs to focus on
    - GP rationale for why a facility is being used
    - Loan terms and structures
    - Default mechanisms
    - LPA and side letter terms
- Opportunities for LPs
    - Early distributions and potentially higher returns
    - Additional capital for portfolio companies

NAV Lender Risks

- Risks
  - Asset value erosion
  - Delayed exits
  - Adverse selection
    - Security is only granted on select investments or pledged collateral becomes more concentrated
  - Liquidity constraints/interest coverage shortfall
- Risk Mitigants
  - LTV triggers – cash traps and rapid amortization
  - Minimum diversification requirements
  - Reserve accounts
  - Limited guarantees
  - Payments in Kind

Preferred Equity Solutions

- Not a new concept; typically used by individual companies rather than at the fund level
- Now seeing more at the fund level
- Hybrid debt like instrument, very bespoke, well suited for funds in highly illiquid assets
  - PIK
- Cash proceeds to lender when investments are sold, not at a fixed maturity
- Limited covenants
- More expensive than NAV facilities
- Provides priority return to preferred providers until it's been repaid plus hurdle
- Purpose is similar to NAV facilities
  - Provides rescue financing
  - Take advantage of market opportunities

- Different than NAV because it has looser covenants
    - No LTV
- Some funds don't have capacity to take on more debt so they go to preferred equity
- European markets have done more preferred deals than US market

Hybrid Facilities

- Collateral and borrowing base includes both uncalled capital and investments
- Often just a high advance rate sub line
- Many loan strategies are using securitization to leverage assets
- Events of default:
    - Similar to sub lines
- Remedies:
    - LTV ratchet with increased cash sweep
    - Sale of investments due to security enforcement