Fund Finance Symposium, Hong Kong: discussing the evolution of subscription line financing

Subscribing to change

Fund subscription lines are a hot topic in the private equity community, despite being an established practice in the industry. Thomas Duffell sits down with four fund finance practitioners to discuss how these vehicles evolve and the worries they have provoked

The Institutional Limited Partners Association became the latest private equity industry voice to wade into the debate on fund level subscription finance when it issued a nine-point guide to help ensure it is used appropriately by fund managers.

The association's contribution in June was a response to increasing debate surrounding the use of these credit vehicles. Among the higher profile industry figures to pipe up was Oaktree Capital's chairman, Howard Marks, who published a white paper highlighting the benefits and risks of fund finance.

Marks warned the use of these subscription lines of credit by private equity funds could add substantial risk for general partners and their investors.

Weeks later at a California Public Employees' Retirement System's investment board meeting, former board member Michael Flaherman also raised concerns over how subscription credit lines were used. The visiting scholar at the University of California Berkeley said the lines "[raise] significant concerns of systemic risk" for the private portfolio and voiced worry about the use of them to "bump up people's compensation."

The central concern is that fund managers could boost their internal rates of return through delaying capital calls after using subscription financing or drawing capital from these lines once an exit is determined and then repaying the lines once it completes.

The use of this financing has become one of the most talked about issues in the private funds universe. Predictably then, the issue engaged trade body Fund Finance Association, which in June hosted an event in Hong Kong attended by 300-plus market practitioners eager to debate subscription credit lines and fund finance's role in private markets.

The event was off the record, but the next day, *PERE* sat down with four fund finance experts who had spoken at the conference to discuss how these products are evolving, the challenges and opportunities lenders and borrowers face in their use, as well as the recent consternation that has arisen.

Alternatives evolution

The products most commonly used are short-term loans made to fund managers for the purpose of deploying capital quickly when an investment opportunity arises. That enables them to call only the capital needed to fund that investment. Nowadays, they are present in all alternative asset classes and across all geographies. But this was not always the case.

"Subscription financing was primarily a US real estate private equity financing product. But it is now commonly used by funds in buyouts, private debt, real estate, infrastructure and other alternative asset classes – from North America to South America, from Europe to Asia," says Albert Tan, finance partner and co-head of the Fund Finance Practice Group at Haynes and Boone, a US-based law firm known for its longstanding subscription financing advisory work.

But, with the needs of private equity fund managers evolving, so too are these financing products. For one, subscription lines are now typically bigger, says David Wasserman, managing director and global group head of subscription secured financing, Sumitomo Mitsui Banking Corporation.

"In Asia, the majority of facilities were bilateral 10-15 years ago and they would rarely exceed $150 million. Now, because of larger fundraises, you need greater bank participation to fill out syndicates and clubs," he says. "Borrowers before had very primary and basic needs, like just dollar funding, whereas now you have a whole different class of investors investing. Now, there are more currencies and not every bank has the capacity to fund every currency."

For global investment managers, such as Gaw Capital Partners, which now has multiple investment vehicles denominated in different currencies, the flexibility provided by multi-currency facilities is a huge benefit, says the firm's chief financial officer in Asia, Kenneth Chiu.

"When we close a deal, we may not want to convert the currency on a very volatile day. With a multi-currency facility I can have the flexibility to draw the local currency to fund the acquisition first and then manage the FX risk later," he says.

Fund financing products are also not only being used by investment managers raising commingled blind pool funds, but for a whole variety of investment structures.

Subscription lines for separate accounts were singled out by the group as one area that was growing rapidly. "It is getting a lot of traction in the market. From a borrower's perspective, there is a big focus on what the advance rate is going to be and what the pricing is going to be. If you are lending purely against one investor, that may require a different set of terms," says Jan Sysel, partner and co-head of fund finance practice at law firm Fried Frank.

Giving the lender's point of view, Wasserman says that while legally and conceptually it is the same process, the risk is clearly more concentrated. "Credit analysis specifically on that investor is more thorough and considered for separate accounts or JV structures. Not all banks will do single managed accounts," he adds.

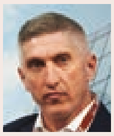
As well as new structures and fund finance products being used by private investment managers, there is also a spate of new lenders in the market. "Initially, we worked with key relationship banks to get these facilities. But the market has become highly competitive and we must now evaluate who we work with," says Gaw's Chiu. "There are many, many new entrants in the market today."

According to Wasserman, having new market entrants pushes down terms, making it more difficult for lenders to defend existing relationships or acquire new ones. But if the fundraising markets remain strong then business for subscription lenders can continue to grow. "We are closing on a $1 billion-plus deal. If there was no active market in Asia, I would not have been able to fill out that syndicate. As long as the pie is getting bigger, and I can maintain

Albert Tan

Co-head of the Fund Finance Practice Group, Haynes and Boone

As co-chair of Haynes and Boone's fund finance practice group, Tan represents investment and commercial banks in connection with bank financings for private equity funds in Asia, Europe and the Americas.

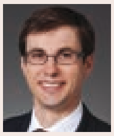


David Wasserman

Managing director and global group head of subscription secured financing, Sumitomo Mitsui Banking Corporation

Wasserman is responsible for the origination, structuring and portfolio management of real estate and subscription based loans to Sumitomo Mitsui Banking Corporation clients on a global basis.

Jan Sysel



Partner and co-head of fund finance practice, Fried Frank

At law firm Fried Frank, Sysel represents sponsors, borrowers, arrangers and lenders on a wide variety of financing transactions primarily in connection with fund formation, as well as leveraged acquisitions, spinoffs, recapitalizations and restructurings, across a broad range of industries.

Kenneth Chiu

CFO Asia, Gaw Capital Partners

Chiu oversees all the finance and treasury functions of Gaw Capital's investments in Asia and is responsible for acquisition financing, financial due diligence, tax planning and the deal structuring of real estate investments.

my share of the pie, I'm going to directly benefit," says Wasserman.

Yet, with newer lenders pushing for market share there is a danger that operating or administrative duties could become neglected, which would will ripple throughout the market. "There's a big problem if banks acted less compliant with the accepted rules and procedures, and then they incur a loss or have some trouble. I think that will be hard to explain to the general market and that might make people think about their exposure to the product," says Wasserman.

Sysel sees positives in a growing market of lenders, however, and says that putting aside the potential funding risks associated with an unfamiliar bank coming into a deal with you, there are generally positives to be gained for fund managers. "There are certainly significant advantages to existing relationships, but it is a positive development in the sense there are more choices for borrowers. I'd advise fund clients to, when appropriate, shop around and see what terms they can get," says Sysel.

Providing the borrower's perspective, Chiu says one of the key tasks is managing the banking relationships. "Of course, we consider pricing, but also the terms of the loan are key, and all the while the long-term lending relationship with an institution is a consideration too," he says. "Outside of that, an understanding of our business is key, and from time to time we may ask for an amendment of the facilities. Certain banks are more flexible and responsive than others. Sometimes, for the bigger banks, the compliance procedures slow them down quite a bit."

When asked if he would sacrifice some pricing savings for a bank with better procedures, Chiu says that a lot of banks are very competitive on pricing, and that when he gets better terms from one bank another will try to match it. "I would not say I would sacrifice or pay more in order for better service. It's more that I understand which banks I want to work with and I consider who is competitive among that shortlist," he says.

All in the communication

Outside of managing banking relationships, Chiu notes that managers and investors communicating the use of subscription lines remains of paramount importance. "At our annual investor forum, we will update our clients about the facilities we have, how much has been utilized. Most of our LPs are institutional investors, so they understand what it is and why we use it," says Chiu.

Yet, when the topic was brought up at an investment board meeting of industry bellwether CalPERS, investors globally took notice. It was shortly after that when ILPA urged members to take responsibility for ensuring they are informed about a manager's use of these lines, and issued guidance to help ensure subscription lines are used appropriately.

"We generally view the guidelines as a positive. We're also pleased that institutional investors are supportive of the use of subscription financing by private equity funds that they invest in, provided that the funds are transparent on their usage and the subscription financing arranged is consistent with ILPA's recommended guidelines," says Tan.

ILPA also asked managers to agree to "reasonable thresholds" for the use of credit lines, such as establishing the longest period for which subscription lines can be used and a maximum percentage of the uncalled capital that can be borrowed against.

However, Tan says this already is happening. "Generally speaking, as you look at many of the funds offering memorandum and limited partnership agreements, leverage

ILPA's nine commandments

The industry trade body issued best practice guidelines on the use of subscription lines to both its investor and fund manager members

1. The IRR clock should start when the credit is drawn, rather than when capital is ultimately called from the LPs
2. Managers should make subscription finance disclosures to their LPs in quarterly reports
3. Managers are advised against using these facilities to cover fund distributions
4. LP advisory committees should add subscription line financing to their meeting agendas
5. Disclosure of investment details should not lag if capital calls are delayed due to the use of subscription finance
6. Managers should include the firm's official policy on credit lines as part of the due diligence packet provided to LPs
7. LPs should request that managers provide the impact of lines of credit on track record
8. LPs evaluating the benchmark performance of managers should take into consideration the potential impact of these lines
9. Provisions addressing the use of subscription facilities within partnership agreements should delineate reasonable thresholds

is described in a fair amount of detail. Everything including: investors' funding obligations, leverage limitations, rights, the assets of funds that can get pledged as collateral and how long you can use the line for.

"Based on the documentation, it seems like LPs are already playing a checks and balances role on this product and how it is used. It appears that from the very inception of the funds, there are ongoing dialogues that exist between GPs and LPs about the use of this financing product."

Nevertheless, ILPA has highlighted the issue of these lines having an artificial impact on a firm's track record. Delayed capital calls can improve a fund's IRR as performance is not calculated until investor capital is called. If, in reality, an investment has been made months before the call, then theoretically, the investment might already be performing by the time the investor money is drawn down, thereby mitigating the J-curve that often occurs at the start. As such, ILPA has asked its members to compare levered and unlevered IRRs of investment managers.

Tan says some investors are already on top of the issue. He notes some are stipulating that should a repayment not happen within a predetermined timeframe they would be deemed to have funded their capital contributions for the purpose of calculating the IRR.

Wasserman adds: "Each LP is going to look at the explicit terms of the partnership agreement and make a value-add decision whether to subscribe to the fund or not. That does not mean every single provision in the partnership is something they are either for or against, but they take the collective to see if this is something they feel comfortable investing in."

Tan says that some views on the issue have been colored by press coverage without fully understanding the intricacies of the product, market practices, or the dialogue between managers and their investors about the use of subscription lines. "I think it's a matter of education for those reading the headlines. In practice, investors and their counsel are very sophisticated and well aware of the usage of this financing product as long as there is transparency from the GP," Tan says.

Sysel echoes this point and highlights the concept of 'true-up' as a one of the LP-favorable aspects of fund subscription financing. A true-up – or equalization – must occur when a fund makes subsequent closings after its first close but has already made investments. As second close investors should be treated as if they had invested at the beginning they share in the income and expenses, gains and losses of the fund. By using a fund subscription line for these early costs when a second close is made the GP does not have to return capital to LPs to get everyone on an equal footing.

"When the fund is raising money and you have multiple equity closings and you must return capital, that can become tricky and administratively burdensome for both GPs and LPs," says Sysel. "When I talk to my fund formation colleagues, this is perhaps one of the biggest positives they see from an LP perspective."

While the roundtable agrees many investors and their managers are already well-versed and active in their subscription line dialogue, the extra attention that has come from high-profile voices such as Oaktree's Marks can only benefit those still requiring education about these products, their benefits and the potential for abuse. Whether they are useful for investment managers and their investors, on the other hand, is of little doubt. □

Harder to underwrite

The evolving nature of the private fund investor base has meant lenders are faced with challenges when underwriting any loans made against their commitments

A collection of household names make up a large portion of the private funds investor base, but new types of capital sources are emerging all the time. For banks providing subscription lines to private fund managers raising from these sources, the underwriting challenge is getting harder.

"The investor base is changing. How involved a lender will be in analyzing this changing investor base is therefore increasing," says Tan.

Wasserman says that each bank has its own underwriting standards and risk tolerances, especially for investors that are reluctant to disclose financial information. "If an investor is willing or unwilling to disclose financial information, each bank needs to make a decision on what is an acceptable risk and reward for them. Some obviously have more risk tolerance than others."

Wasserman says there are other methods to help investors that may not disclose certain information get comfortable during the underwriting process.

Each bank has its own underwriting standards and risk tolerances. "You ask yourself, what type of other collateral is there? Are you getting opinions? What is the enforceability? What other sources of information are available? There may not be full financial disclosure, but we live in an information age where you can find out certain details and create a fact pattern on an investor if some distress came about."