Whose line is it anyway?

Subscription credit lines have become an essential component of financing for private equity firms. *pfm* gathered private equity executives, a lawyer and a banker to discuss how they are treated in the industry

by DOMINIC DIONGSON

photography by LEA RUBIN

Back row (from left): Joshua Cherry-Seto, Michael Robin.
Front row (from left): Jonathan Schwartz,
Ellen Gibson McGinnis, Noah Becker

Sponsored by: Haynes and Boone

The subscription line of credit, conceived in the late 1980s for real estate developers, has become a necessary form of fund financing for private equity firms to cover short-term needs. These facilities allow GPs to deploy capital at short notice using short-term debt and delay calling capital from investors.

In June, *pfm* gathered three executives from private equity firms, a banker who oversees credit products and an attorney who specializes in the facilities to discuss their impact on private equity.

"You have some deals that are going along – they might close, they may not close – and you have expenses," says Jonathan Schwartz, chief operating officer of NewSpring Capital, a lower mid-market firm with about $1.7 billion in assets under management.

"We've always used these lines of credit to manage the cashflow of the business where I can get easy access to capital," he says. "I can then use it as I see fit, and then pay it down at a 5 percent capital call, 10 percent capital call so that it's meaningful to the investor. And it's not a nuisance. Maybe you're calling it two or three times a year, not five or six. So that's the way I've looked at it for the past 20 years."

Borrowing for bridge financing is big business for banks. The Fund

> "Things would have to go really wrong for [LPs] not to be able to meet a capital call, minimizing any systemic risk associated with having their commitments called all at once"
>
> **Michael Robin**

Finance Association, an advocacy group for fund finance, cites one estimate that puts the value of committed subscription credit facilities held by banks and other financial institutions worldwide at about $400 billion.

Staying levered

While there is currently no oversight on subscription lines of credit, private equity firms are closely monitoring regulators' take on debt, both in terms of its effect on performance and whether it represents systemic risk.

The lower to mid-market space in private equity and the larger leveraged buyout firms have different views on what debt looks like, says Joshua Cherry-Seto, chief financial officer at Blue Wolf Capital, a mid-market firm. While financial firms are far from the highly leveraged days of the 2008 financial crisis brought on by credit derivatives, private equity shops should pay attention to their debt levels, even when that means drawing on temporary lines of credit, he said.

One way regulators should view debt levels, Cherry-Seto says, is trying to figure out a private equity firm's look-through leverage. The look-through leverage is the real leverage on its own, though each instance is ring-fenced from affecting the other portfolio companies, he says.

For many mid-market firms, including Blue Wolf, their level of debt has remained quite modest, usually at two to four times EBITDA levels, despite rising valuations, he adds.

"The fund level debt, to the extent it is short term – ours is at 90 days – is fully backed by unfunded commitments and is not very at risk, particularly with required coverage ratios," Cherry-Seto says.

As a way of monitoring systemic risk among its clients, Citi Private Bank maintains a database of thousands of limited partners, most of which are pension funds, sovereign wealth funds and other institutional investors, says Michael Robin, a managing director at Citi who specializes in subscription credit facilities. Performing that monitoring includes tracking their allocations to

private equity – invested and committed. The bank also tracks their liquidity in cash, fixed income securities, public equities and hedge funds, Robin says.

The data show the biggest investors in private equity, mostly pension funds, have only 10 percent of their plan assets on average invested in private equity (as low as 5 percent and potentially as high as 15 percent), including the unfunded commitment.

Liquidity for these funds tends to be at 60-70 percent of plan assets, he says.

"Things would have to go really wrong for them not to be able to meet a capital call, minimizing any systemic risk associated with having their commitments called all at once. The institutional investors will still be able, especially among the bigger investors, to meet their capital call," Robin says.

Between the lines

Noah Becker, CFO of LLR Partners, says that while they have some leverage characteristics, the use of lines – and for that matter, of debt at portfolio companies – does not create leverage risk in the same way as true leveraged positions because they are self-contained. If one portfolio company is overleveraged, it doesn't affect other portfolio companies. Similarly, line usage doesn't increase the risk to LPs. If their commitment is $100 million, then $100 million is their maximum exposure; their capital at risk hasn't increased.

Still, LPs would want to be informed, Becker says.

"The LPs want to learn more about what's going on to understand if there is systemic risk in these lines. And I almost believe that as more disclosures come out and they understand and further analyze the pros and cons

AROUND THE TABLE

Jonathan Schwartz is president and chief operating officer at NewSpring Capital, a lower mid-market firm based in Radnor, Pennsylvania. The firm has invested in more than 140 companies since it was founded in 2000, and has about $1.7 billion in assets under management.

Noah Becker is the chief financial officer for lower mid-market firm LLR Partners, which he joined in 2012. Based in Philadelphia, LLR targets a set of industries, with a focus on technology and services businesses and education, and has raised more than $3 billion across five funds.

Joshua Cherry-Seto is chief financial officer and chief compliance officer at New York-based mid-market Blue Wolf Capital Partners, which has $1.5 billion in AUM. The firm's portfolio of companies includes energy, healthcare, forest and building products and infrastructure and electrical services.

Michael Robin is a managing director and the global head of financial sponsors lending at Citi Private Bank. Robin oversees credit products tailored to the needs of private equity funds, related management companies and their sponsor groups. Prior to joining Citigroup in 1995, Robin held various positions at NatWest Bank, Fleet Bank and Barclays Bank in mid-market lending.

Ellen Gibson McGinnis is a partner at law firm Haynes and Boone, a trusted counsel for US and foreign commercial and investment banks as lenders to private equity funds. McGinnis specializes in subscription-secured credit facilities, having worked on the product since its initial development in the late 1980s. She also serves as co-chair of the firm's fund finance practice group.

of the lines I think many will lean toward using lines more heavily."

Transparency matters

So, how much should LPs be told?

In June 2017, the Institutional Limited Partners Association issued guidelines on best practice for LPs and GPs on subscription lines of credit. One of the concerns the lobby group noted was the alignment of interests between the parties and whether facilities should be used to boost fund performance figures.

For Cherry-Seto, investors have been discussing in recent years management of the J-curve and using the lines of credit to extend how long it takes to take capital calls. For investors focused on the internal rate of return, this is a benefit, but at the expense of a lower ultimate multiple.

"This is not a universal preference, so we continue to focus on how capital call lines give us greater operational efficiency," he says.

Becker says that his firm finds LPs are asking for information based on the ILPA guidelines, and so far it hasn't received any pushback on terms for the subscription lines.

"We are starting to get the questions and comments on providing the ILPA information," he says. "We're going to do it. We're happy to do it. The more information the LPs have, the better – the more they understand it. Informed LPs mean a better relationship, and we'll see where that moves. We don't believe in publishing data for the sake of data and just sending a bunch of numbers out. But we're always happy to provide meaningful information."

Similarly, Schwartz is not experiencing LP pushback on credit lines when drafting limited partnership agreements. His firm typically pays back within six months.

That would be in line with ILPA's recommend guideline of a maximum of 180 days outstanding.

Robin points out Citi's data show LPs tend to be more discerning when it comes to first-time fund managers. For them, LPAs may contain limits set on the subscription lines, such as size of the subscription facilities as a percentage of fund size and a maximum length of time that an individual advance under the facility can

"The consensus is the more disclosure, the better. Transparency is good, and you want your LPs to have full information"

Ellen Gibson McGinnis

be outstanding before the capital is called. Established fund managers, which have been in the business for 10 to 20 years, for example, often have greater flexibility and face fewer limits in their LPAs.

Providing the right info

The Fund Finance Association criticized the ILPA guidelines when they came out, particularly the recommendation that the maximum size of the line be 15-25 percent of the fund size. The FFA argued funds have different strategies and leverage needs.

Ellen Gibson McGinnis, a partner at Haynes and Boone, says her law firm had conversations with a representative of ILPA after the guidelines were issued, and hosted an industry panel which included Jennifer Choi, managing director for industry affairs from ILPA, to discuss them.

McGinnis mentions that there is more than one "market" in the subscription facility space, and says her initial reaction to the guidelines was that some of the issues related to provisions that are never included in most facilities, so there was some question about how the concerns arose.

Drawing from a recent conference, she says it became clear that funds would be able to better provide consistent information if LPs were consistent about what they wanted, and the ILPA guidelines are useful for standardizing information.

Some required disclosures, however, might be problematic for subscription line lenders. One such example is requiring certain financial information to be included in capital calls that might not be available to the lenders, in order for them to exercise call rights in the event of a default.

"You have to be careful to think about narrowing that to essential information for a capital call and repayment of debt situation," she says. "As the terms of LPAs and facility documents change, you have to be aware of how access to the unfunded commitments may be impacted, to make sure you're not in a really difficult situation."

Still, "the consensus is the more disclosure, the better. Transparency is good, and you want your LPs to have full information," McGinnis says.

Getting the best lender

Robin says that when Citi started its subscription line business in 1999, there were fewer competitors. Now, the bank lends to a few hundred funds across 20 countries, but

"We continue to focus on how capital call lines give us greater operational efficiency"

Joshua Cherry-Seto

competition is tight and new lenders are entering the business each year.

In 2014, Citi decided to form a specialized group handling subscription lines. Worldwide it has 50 to 60 people who are involved in underwriting, portfolio management and risk management.

In one recent case, Citi worked closely with a new client and closed on a $50 million subscription just five days after receiving the request for a time-sensitive transaction.

When it comes to deciding on a bank, for the most part, PE firms are sticking with ones they are comfortable doing business with.

There's clearly a lot of competition, Becker says, and LLR took out a bidding process for one of the firm's funds to find the best rates on a credit line.

"We're not going to the last basis point necessarily, to move to somebody who's newer to the space from somebody who's been in it forever and who's going to be there with us and can roll with all the punches."

Schwartz agrees: "It's like anything else. It's the relationship and the flexibility, and do they understand the business. It's what you're doing and what the line is for."

In its guidelines, ILPA recommends subscription lines are not used to cover fund distributions for an exit of a portfolio company. Schwartz, Cherry-Seto and Becker point out they have only drawn down on credit to cover investments and operational expenses but have never used one to pay for distributions.

Robin says that it is very rare for funds to borrow money using these lines to make distributions to investors. However, he has seen situations in Asia where, on the sale of an asset, there have been reviews of income tax filings, causing delays in the money leaving the country. Some funds have therefore borrowed money in limited amounts, and for short periods of time, to bridge the eventual receipt of the sale proceeds.

Cheaper financing

The popularity of the subscription credit line comes at a time when interest rates are low. The panelists argue that if rates should rise from

> "The LPs want to learn more about what's going on to understand if there is systemic risk in these lines"
>
> **Noah Becker**

> “We’ve always used these lines of credit to manage the cashflow of the business where I can get easy access to capital”
>
> **Jonathan Schwartz**

current levels, the use of subscription lines will continue as the firms continue to invest. Cherry-Seto says that subscription lines remain hundreds of basis points lower than commercial lending, and if needed, could hedge against a rise in interest rates.

The US Federal Reserve’s bank prime loan rate, which banks use as a benchmark to set their commercial lending rates, stood at 4.75 percent in early June.

“At some point hedging will come back, too,” Cherry-Seto says. “When you look at prior to the 2008 global financial crisis, it was normal at the portfolio company levels for us to be required to do something about interest rate hedging. When the rate goes to zero, nobody seems to care. But we actually had our first instance recently of a portfolio company lending facility requiring an interest rate hedge.

“The market continues to expect a quicker rise of rates than what we have seen. They’ve been doing that for a while. At some point they’ll be right, but I don’t think that ‘some point’ is now.”

Walking the line

The future of the subscription line is clear among private equity firms. It’s a necessary fund financing function for doing business. But it does carry some special considerations, and there are debates on its non-investment use, as some firms tap it for early distributions in portfolio company exits.

Becker says in the future investors will continue to demand more information and continue to better understand how the subscription credit lines are being used. There is the possibility of a split – one set of LPs which want firms to borrow lightly for regulation, tax or other reasons and another set very focused on the internal rate of return and which will therefore want firms to borrow heavily.

Ultimately, it’s up to private equity firms to know what their LPs want, to negotiate the best deal with their lender and to follow the guidance set out in the LPA. ■